UNRELATED BUSINESS INCOME TAX

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

JUNE 22, 25, 26, 29, AND 30, 1987

Part 1 of 3

JUNE 22 AND 25, 1987

Serial 100–26

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

80–517 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

4781-16

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J.J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
FRANK J. GUARINI, New Jersey
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
ROBERT T. MATSUI, California
BERYL ANTHONY, Jr., Arkansas
RONNIE G. FLIPPO, Alabama
BYRON L. DORGAN, North Dakota
BARBARA B. KENNELLY, Connecticut
BRIAN J. DONNELLY, Massachusetts
WILLIAM J. COYNE, Pennsylvania
MICHAEL A. ANDREWS, Texas
SANDER M. LEVIN, Michigan
JIM MOODY, Wisconsin

JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
DICK SCHULZE, Pennsylvania
BILL GRADISON, Jr., Ohio
WILLIAM M. THOMAS, California
RAYMOND J. McGRATH, New York
HAL DAUB, Nebraska
JUDD GREGG, New Hampshire
HANK BROWN, Colorado
ROD CHANDLER, Washington

Robert J. Leonard, *Chief Counsel*
M. Kenneth Bowler, *Staff Director*
A.L. Singleton, *Minority Chief of Staff*

Subcommittee on Oversight

J.J. PICKLE, Texas, *Chairman*

BERYL ANTHONY, Jr., Arkansas
RONNIE G. FLIPPO, Alabama
BYRON L. DORGAN, North Dakota
HAROLD FORD, Tennessee
CHARLES B. RANGEL, New York
ANDY JACOBS, Jr., Indiana

DICK SCHULZE, Pennsylvania
BILL FRENZEL, Minnesota
WILLIAM M. THOMAS, California
RAYMOND J. McGRATH, New York

CONTENTS

Page

Press releases announcing the hearings 2

WITNESSES

U.S. Department of the Treasury, O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy) 11
Internal Revenue Service, Hon. Lawrence B. Gibbs, Commissioner of Internal Revenue, and Robert I. Brauer, Assistant Commissioner for Employee Plans and Exempt Organizations 61
U.S. Small Business Administration, Frank S. Swain, Chief Counsel for Advocacy 89
U.S. General Accounting Office, Jennie S. Stathis, Associate Director, General Government Division 129

Alabama State Lodge, Fraternal Order of Police, Horace W. Hodges 1687
Alabama Symphony Orchestra, Edward Wolff 1146
Allen, Robert L., Consortium of University Film Centers 508
Alpha Therapeutic Corp., H. Edward Matveld and Edward A. Colton 1069
Altman, Steven, Texas A&I University, on behalf of American Association of State Colleges and Universities 396
Amador Corp., James Wm. Johnson 533
American Arts Alliance, William P. Blair, C. William Stewart, Edward Purrington, and Edward Wolff 1146
American Association of Museums, Willard Boyd, Mary Schmidt Campbell, Robert J. McQuarie, and Beverly Barsook 1109
American Association of Retired Persons, Cyril F. Brickfield 1620
American Association of State Colleges and Universities, Steven Altman 396
American Bar Association, Section of Taxation, John B. Jones, Jr 1737
American Bus Association, Susan Perry 640
American Clinical Laboratory Association, Harry Groome 818
American Council for the Arts, Laura Lee Blanton 1124
American Council of Independent Laboratories, Grover C. Williams 551
American Council on Education (and 18 other higher education associations), John DiBiaggio 359
American Healthcare Institute, Merlin K. DuVal, M.D 927
American Heart Association, Thom R. Winkler 1026
American Hospital Association, Jack W. Owen and John D. Leech 919
American Institute of Certified Public Accountants, Federal Taxation Executive Committee, Herbert J. Lerner 1749
American Red Cross, Lewellys F. Barker, M.D 1066
American Society of Association Executives, Roderick L. Geer 1633
American Society of Travel Agents, Inc., Earlene L. Causey 606
American Speech-Language-Hearing Association, Patricia R. Cole 1306
American Veterinary Medical Association, Alton F. Hopkins and Harold Knirk 741
Arena Stage, C. William Stewart 1146
Asher, Thomas M., HemaCare Corp 1082
Ashley, James W., YMCA of the USA 1189
Association of Governing Boards of Universities and Colleges, A.J. Pfister 1012
Association of Business Publishers, Stephen Feldman 1357
Association of Telemessaging Services International, Inc., Mark J. Golden 879
Association of the Bar of the City of New York, Committee on Nonprofit Organizations, Carolyn C. Clark 1756

Page

Association of Washington Business, Gerald R. Brong 523
Austin Center for Speech-Language-Learning Disorders, Patricia R. Cole 1306
Barker, Lewellys F., M.D., American Red Cross 1066
Barrett, Pat, United Way of America 1017
Barsook, Beverly, Museum Store Association, and American Association of Museums 1109
Beck, J. Edward, Jr., National Easter Seal Society 1034
Bennett, James T., George Mason University 1796
Berno, Donald C., United States Chamber of Commerce 327
Betts, Richard, YMCAs of Philadelphia, and YMCA of the USA 1195
Blair, William P., American Arts Alliance 1146
Blanton, Laura Lee, American Council for the Arts 1124
Boyd, Willard, Field Museum of Natural History, and American Association of Museums 1109
Brickfield, Cyril F., American Association of Retired Persons 1620
Brong, Gerald R., Association of Washington Business; and International Communications Industries Association 523
Bruce, Robert J., Widener University, on behalf of National Association of Independent Colleges and Universities 411
Business Coalition for Fair Competition, Joseph F. O'Neil, John Satagay, and Kenton Paddy 212
California Business Coalition, Alice Gallagher Reed 1394
Campbell, Mary Schmidt, Studio Museum in Harlem, and American Association of Museums 1109
Carlton, Donald M., Radian Corp., and Professional Services Council 581
Carr, Jeff, Vanderbilt University 416
Cascade Athletic Club, Frank Eisenzimmer 1219
Catholic Health Association, Sister Bernice Coreil 906
Causey, Earlene L., American Society of Travel Agents, Inc 606
Clark, Carolyn C., Committee on Nonprofit Organizations, Association of the Bar of the City of New York 1756
Cohen, Sheldon S., National Assembly of National Voluntary Health & Social Welfare Organizations 232
Cole, Patricia R., Austin Center for Speech-Language-Learning Disorders, and American Speech-Language-Hearing Association 1306
Colton, Edward A., Alpha Therapeutic Corp 1069
Consortium of University Film Centers, Robert L. Allen 508
Coreil, Sister Bernice, Catholic Health Association 906
Council on Research and Technology, Joseph A. Saloom 499
Cousins, Solon B., YMCA of the USA 1172
Crowson, James L., University of Texas System 1699
Cummings, Robert S., Massachusetts Society for the Prevention of Cruelty to Animals 735
Dale, Harvey P., New York University School of Law 1857
DiBiaggio, John, National Association of State Universities and Land-Grant Colleges, on behalf of the American Council on Education (and 18 other higher education associations) 359
Ducate, Douglas L., Society of Petroleum Engineers, and National Association of Exposition Managers 1712
DuVal, Merlin K., M.D., American Healthcare Institute 927
Eisenzimmer, Frank, Cascade Athletic Club, on behalf of the International Racquet Sports Association 1219
Family Service America, Geneva B. Johnson and Patricia A. Langley 1041
Feldman, Stephen, Association of Business Publishers 1357
Fellman, Steven J., Textile Rental Services Association of America, on behalf of Gerald S. Ostrow 823
Field Museum of Natural History, Willard Boyd 1109
Fiscal Planning Services, Stuart I. Rabinowitz 1329
Fraternal Order of Police, Illinois State Troopers Lodge No. 41, David Lumerman 1670
Fraternal Order of Police, State Lodge of Alabama, Horace W. Hodges 1687
Fremont-Smith, Marion R., Independent Sector 153
Gambardella, Frank, National Association of Portable X-Ray Providers 1335
Garber, Charles A., Structure Probe, Inc 1318
Garrett, Spencer, Pierpoint Racquet Club, on behalf of the International Racquet Sports Association 1250
Geer, Roderick L., Million Dollar Round Table, and American Society of Association Executives 1633

Page
Golden Mark J., Association of Telemessaging Services International, Inc. 879
Gray, Bradford H., Institute of Medicine, National Academy of Sciences 995
Groome, Harry, American Clinical Laboratory Association 818
Grosvenor, Gilbert M., National Geographic Society 1609
Guenther, George C., Talmage Tours, Inc., and National Tour Association, Inc. 622
Hager, Susan, United Way of New York State, and United Way of America 1017
Hansmann, Henry, Yale Law School 1832
Hasson, James K., Jr., Sutherland, Asbill & Brennan, and Emory University 1816
Health Industry Distributors Association, Paul B. Simmons and Robert H. Wilbur 809
HemaCare Corp., Thomas M. Asher 1082
Hess, Earl H., United States Chamber of Commerce 327
Hodges, Horace W., Fraternal Order of Police, State Lodge of Alabama 1687
Holm, Robin, National Hearing Aid Society 793
Hopkins, Alton F., American Veterinary Medical Association 741
Howe, Jonathan T., National School Boards Association 1293
Hoyt, John A., Humane Society of the United States 745
Hughes, Kingdon R., Subsurface Library 1327
Humane Society of the United States, John A. Hoyt 745
Hutton, William T., Hastings College of the Law, University of California 730
Illinois State Troopers Lodge No. 41, Fraternal Order of Police, David Lumerman 1670
Independent Sector, Marion R. Fremont-Smith 153
Inman, Thomas E., II, Virginia Home Medical 866
International Communications Industries Association, Gerald R. Brong 523
International Racquet Sports Association:
  John McCarthy 1205
  Frank Eisenzimmer 1219
  Spencer Garrett 1250
International Taxicab Association, Jerilyn Nettnin 872
Johnson, Geneva B., Family Service America 1041
Johnson, James Wm., Amador Corp 533
Jones, John B., Jr., American Bar Association, Section of Taxation 1737
Jones, Linda Wolf, Nonprofit Coordinating Committee of New York 316
Jones, Ray, Texas Hearing Aid Association 1303
Kertz, Consuelo Lauda, Business School, Emory University 723
Knirk, Harold, American Veterinary Medical Association 741
Langley, Patricia A., Family Service America 1041
Leech, John D., American Hospital Association 919
Lehrfeld, William J., Shriners Hospitals for Crippled Children 935
Lerner, Herbert J., Federal Taxation Executive Committee, American Institute of Certified Public Accountants 1749
Littleton History Museum, Robert J. McQuarie 1109
Lumerman, David, Fraternal Order of Police, Illinois State Troopers Lodge No. 41 1670
Mason, Thomas, Notre Dame University, on behalf of National Association of College and University Business Officers 403
Massachusetts Society for the Prevention of Cruelty to Animals, Robert S. Cummings 735
Matveld, H. Edward, Alpha Therapeutic Corp 1069
Mayer, Robert, National Association of Small Business Against Hospital Unfair Competition 864
McCarthy, John, International Racquet Sports Association 1205
McQuarie, Robert J., Littleton History Museum, and American Association of Museums 1109
Michigan Humane Society, David K. Wills 753
Million Dollar Round Table, Roderick L. Geer 1633
Montrose Animal Health Center, Nolan P. Rubin 751
Motley, John J., III, National Federation of Independent Business 270
Museum Store Association, Beverly Barsook 1109
National Academy of Sciences, Institute of Medicine, Bradford H. Gray 995
National Assembly of National Voluntary Health & Social Welfare Organizations, Sheldon S. Cohen and W. Harrison Wellford 232
National Association of College and University Business Officers, Thomas Mason 403
National Association of Exposition Managers, Douglas L. Ducate 1712

Page
National Association of Independent Colleges and Universities, Robert J. Bruce 411
National Association of Portable X-Ray Providers, Frank Gambardella 1335
National Association of Regional Media Centers, Mark L. Richie 513
National Association of Small Business Against Hospital Unfair Competition, Robert Mayer 864
National Association of State Universities and Land-Grant Colleges, John DiBiaggio 359
National Easter Seal Society, J. Edward Beck, Jr 1034
National Federation of Independent Business, John J. Motley III and Abraham Schneier 270
National Geographic Society, Gilbert M. Grosvenor 1609
National Hearing Aid Society, Robin Holm 793
National School Boards Association, Jonathan T. Howe 1293
National Tour Association, Inc., George C. Guenther 622
Nettin, Jerilyn, International Taxicab Association 872
Nonprofit Coordinating Committee of New York, Peter Swords and Linda Wolf Jones 316
Notre Dame University, Thomas Mason 403
O'Neil, Joseph F., Business Coalition for Fair Competition 212
Ostrow, Gerald S. (*See* Textile Rental Services Association of America.)
Owen, Jack W., American Hospital Association 919
Paddy, Kenton, Business Coalition for Fair Competition 212
Perry, Susan, American Bus Association 640
Peterson, Eric C., United Bus Owners of America 634
Pfister, A.J., Association of Governing Boards of Universities and Colleges 1012
Pierpoint Racquet Club, Spencer Garrett 1250
Professional Services Council, Donald M. Carlton 581
Purrington, Edward, Washington Opera, and American Arts Alliance 1146
Rabinowitz, Stuart I., Fiscal Planning Services 1329
Radian Corp., Donald M. Carlton 581
Reed, Alice Gallagher, California Business Coalition 1394
Richie, Mark L., National Association of Regional Media Centers 513
Rose-Ackerman, Susan, Columbia University 1830
Rubin, Nolan P., Montrose Animal Health Center 751
Rudney, Gabriel, Institution for Social and Policy Studies, Yale University 985
Saloom, Joseph A., Council on Research and Technology 499
Sanford, Hon. Terry, a U.S. Senator from the State of North Carolina 353
Satagaj, John S., Small Business Legislative Council 1348
Satagay, John, Business Coalition for Fair Competition 212
Schneier, Abraham, National Federation of Independent Business 270
Seay, J. David, United Hospital Fund of New York 951
Shillingburg, J. Edward, Lord, Day & Lord 1845
Shriners Hospitals for Crippled Children, William J. Lehrfeld 935
Simmons, Paul B., Health Industry Distributors Association 809
Small Business Legislative Council, John S. Satagaj 1348
Society of Petroleum Engineers, Douglas L. Ducate 1712
Stark, Hon. Fortney H. (Pete), a Representative in Congress from the State of California 766
Stewart, C. William, Arena Stage, and American Arts Alliance 1146
Structure Probe, Inc., Charles A. Garber 1318
Studio Museum in Harlem, Mary Schmidt Campbell 1109
Subsurface Library, Kingdon R. Hughes 1327
Swords, Peter, Nonprofit Coordinating Committee of New York 316
Talmage Tours, Inc., George C. Guenther 622
Texas A&I University, Steven Altman 396
Texas Hearing Aid Association, Ray Jones 1303
Textile Rental Services Association of America, Steven J. Fellman on behalf of Gerald S. Ostrow 823
Trinity Engineering Testing Corp., Grover C. Williams 551
United Bus Owners of America, Eric C. Peterson 634
United Hospital Fund of New York, J. David Seay 951
United States Chamber of Commerce, Earl H. Hess and Donald C. Berno 327
United Way of America, Susan Hager and Pat Barrett 1017
United Way of New York State, Susan Hager 1017
University of Texas System, James L. Crowson 1699
Vanderbilt University, Jeff Carr 416
Virginia Home Medical, Thomas E. Inman II 866

Page
Washington Opera, Edward Purrington 1146
Webster, George D. Webster, Chamberlain, Bean & McKevitt 1801
Wellford, W. Harrison, National Assembly of National Voluntary Health & Social Welfare Organizations 212
Widener University, Robert J. Bruce 411
Wilbur, Robert H., Health Industry Distributors Association 809
Williams, Grover C., Trinity Engineering Testing Corp., and American Council of Independent Laboratories 551
Wills, David K., Michigan Humane Society 753
Winkler, Thom R., American Heart Association 1026
Wolff, Edward, Alabama Symphony Orchestra, and American Arts Alliance 1146
YMCA of the USA:
  Solon B. Cousins 1172
  James W. Ashley 1189
  Richard Betts 1195
YMCAs of Philadelphia, Richard Betts 1195

SUBMISSIONS FOR THE RECORD

ADAPSO, George T. DeBakey, statement 1880
Airport Limousine Service Inc., James L. Sunstein, letter 1882
Allen, William E., D.D.S., American Dental Association, letter 1886
American Bankers Association, statement 1883
American Collectors Association, John W. Johnson, statement 1638
American Dental Association, William E. Allen, D.D.S., letter 1886
American Diabetes Association, Inc., statement 1895
American Legion, Robert W. Spanogle, statement and attachments 1901
American Medical Association, statement 1917
American Society for Personnel Administration, statement 1922
American Society of Association Executives, John W. Johnson, statement 1638
Andrews, Martha A., Businesses and Associations for a Strong Economy, letter and attachments 1968
Applied Research Associates, Paul O. Davis, letter 1926
Arizona Hearing Aid Society, K. Ray Katz, letter and attachment 1928
Aronofsky, David J., Earl W. Kintner, Michael D. Barnes, and Marc L. Fleischaker, National Association of College Stores, joint letter 2222
Audio Hearing Aid Center, Inc., Lawrence J. House, letter 1931
Audio Prosthetics, Samuel I. Kiser, letter 1932
Audiologic Services, Albert P. Silverio, letter 1933
Bakalars, Edward J., La Crosse Hearing Aid Center, letter 2198
Bankers Committee for Tax Equality, statement 1934
Barnes, Michael D., Earl W. Kintner, Marc L. Fleischaker, and David J. Aronofsky, National Association of College Stores, joint letter 2222
Bartolucci, John, Beltone Hearing Aid Service, Springfield, Mass., letter 1953
Beltone Hearing Aid Center:
  Ervin E. King, Billings, Montana, letter and attachment 1940
  Karen S. Maas, Traverse City, Michigan, letter and attachments 1942
  Eules T. Morgan, Florence, S.C., letter 1949
  James Ogurek, Ogurek Enterprises, Inc., Wausau, Wisconsin, letter 1950
Beltone Hearing Aid Service:
  John Bartolucci, Springfield, Mass., letter 1953
  James A. Bohren, Sheboygan, Wisconsin, letter and attachments 1956
  William E. King, Pittsburgh, Pa., letter and attachment 1963
  Richard Pitt, Statesboro, Georgia, letter 1965
  Curt Wallis, Peggy Wallis, J. Michael Wallis, Josh Villasenor, and Karen W. Villasenor, Odessa, Texas, joint letter 1966
Bethlehem Hearing Aid Center, Thomas R. Stephens, letter 1967
Boehlert, Hon. Sherwood, a Representative in Congress from the State of New York, and Hon. Bob Wise, a Representative in Congress from the State of West Virginia, joint letters 2356
Bohren, James A., Beltone Hearing Aid Service, Sheboygan, Wisconsin, letter and attachments 1956
Bollinger, Terry, Mid-Kansas Acousticon, Inc., letter 2220
Businesses and Associations for a Strong Economy, Martha A. Andrews, letter and attachments 1968

Page
Cappabianca, Hon. Italo S., Select Committee to Study Business Activities of Nonprofits, Pennsylvania House of Representatives, statement and attachment 1726
Carter, Rev. James C., Loyola University, statement 2200
Catholic Charities USA, statement 2145
Christensen, Elfreda, Elfreda Christensen Hearing Aids, letter 2152
Cook-Witter, Inc., Randall F. Witter, letter 2153
Councilman, Dorothy, Hearing Aid Center, letter and attachments 2177
Davis, Paul O., Applied Research Associates, letter 1926
DeBakey, George T., ADAPSO, statement 1880
Dewey, Ballantine, Bushby, Palmer & Wood, statement 2154
Drake Hearing Aid Center, Timothy L. Drake, letter 2158
Eaneman, Robert G., Volunteer Trustees of Not-For-Profit Hospitals, statement 2353
Edwards, Wade H., Florida Hospital Association, Inc., letter 2163
Erie Audiology & Hearing Aid Center, Neal E. Mann, letter 2161
Evans, Sam, YMCA, National Board, statement 1202
Fishman, Joseph D., New Jersey Guild of Hearing Aid Dispensers, letter 2288
Fleischaker, Marc L., Earl W. Kintner, Michael D. Barnes, and David J. Aronofsky, National Association of College Stores, joint letter 2222
Florida Chiropractic Association, Inc., Ed Williams, letter 2162
Florida Hospital Association, Inc., Wade H. Edwards, letter 2163
Galles, John Paul, National Small Business United, statement 2284
Gillum, Charlie, Charlie Gillum United Hearing Aid Service, letter 2164
Goodwill Industries of America, Inc., statement 2165
Greene, Cary W., Hearing Aid Specialists, letter 2181
Hackett, Stanley H., Jebco, Inc., letter 2188
Hammond, Dean, Hammond, Inc., on behalf of U.S. Cartographic Industry Members, statement and attachments 2345
Haspel, Donald P., National Office Products Association, statement 2282
Haviland Hearing Aids, Richard H. Haviland, letter 2175
Healthcare Financial Managment Association, statement 2182
Hearing Aid Associates, William J. and Dolores P. Kemple, joint letter 2176
Hearing Aid Center, Dorothy Councilman, letter and attachments 2177
Hearing Aid Specialists, Cary W. Greene, letter 2181
Hieb, Carol J., Statewide Hearing Aid Center, letter and attachments 2328
Hospital Trustees of New York State, statement 2185
House, Lawrence J., Audio Hearing Aid Center, Inc., letter 1931
Jebco, Inc., Stanley H. Hackett, letter 2188
Johnson, John W., American Collectors Association, and American Society of Association Executives, statement 1638
Katz Hearing Aid Center, Kalman R. Katz, statement and attachment 2191
Katz, K. Ray, Arizona Hearing Aid Society, letter and attachment 1928
Kemple, William J., and Dolores P., Hearing Aid Associates, joint letter 2176
Kerr, Jeannette, MAICO Hearing Aid Service, letter 2209
King, Ervin E., Beltone Hearing Aid Center, Billings, Montana, letter and attachment 1940
King, William E., Beltone Hearing Aid Service, Pittsburgh, Pa., letter and attachment 1963
Kintner, Earl W., Michael D. Barnes, Marc L. Fleischaker, and David J. Aronofsky, National Association of College Stores, joint letter 2222
Kiser, Samuel I., Audio Prosthetics, letter 1932
La Crosse Hearing Aid Center, Edward J. Bakalars, letter 2198
Lake, F. David, Jr., University Patents, Inc., statement 2342
Lifset, Reid J., Department of Political Science, Massachusetts Institute of Technology, statement and attachment 2210
Loyola University, Rev. James C. Carter, statement 2200
Maas, Karen S., Beltone Hearing Aid Center, Traverse City, Michigan, letter and attachments 1942
MAICO Hearing Aid Service, Jeannette Kerr, letter 2209
Mann, Neal E., Erie Audiology & Hearing Aid Center, letter 2161
Mattox, Hon. Jim, Attorney General, State of Texas, letter 2336
Mertz, George J., National Industries for the Blind, statement 2272
Mid-Kansas Acousticon, Inc., Terry Bollinger, letter 2220
Miller, C.L. "Kip", and Elizabeth "Betty", Orange Hearing Aids, joint letter 2298
Morgan, Eules T., Beltone Hearing Aid Center, Florence, S.C., letter 1949
Murphy, Robert, Statewide Hearing Aid Center, letter and attachments 2334

Page

National Association of College Stores, Earl W. Kintner, Michael D. Barnes, Marc L. Fleischaker, and David J. Aronofsky, joint letter 2222
National Association of Home Builders, statement 2238
National Association of Retail Druggists, John M. Rector, letter and attachments 2241
National Industries for the Blind, George J. Mertz, statement 2272
National Office Products Association, Donald P. Haspel, statement 2282
National Small Business United, John Paul Galles, statement 2284
National Society of Professional Engineers, Donald G. Weinert, letter 2286
New Jersey Guild of Hearing Aid Dispensers, Joseph D. Fishman, letter 2288
Novak Hearing Center, Charles J. Novak, letter 2291
Ogurek, James, Ogurek Enterprises, Inc., Beltone Hearing Aid Center, Wausau, Wisconsin, letter 1950
Oliver, Daniel, Federal Trade Commission, statement 2293
Orange Hearing Aids, C. L. "Kip" and Elizabeth "Betty" Miller, joint letter 2298
Pitt, Richard, Beltone Hearing Aid Service, Statesboro, Georgia, letter 1965
Pennsylvania House of Representatives, Select Committee to Study Business Activities of Nonprofits, Hon. Italo S. Cappabianca, statement and attachment 1726
Powell, R. K., Silver Spring, Maryland, letter 2299
Rector, John M., National Association of Retail Druggists, letter and attachments 2241
Schauer Hearing Aid Center's of North Dakota, Floyd Schauer, et al, joint letter and attachments 2305
Silverio, Albert P., Audiologic Services, letter 1933
Society of National Association Publications, statement 2316
Society of the New York Hospital, statement 2318
Spanogle, Robert W., American Legion, statement and attachments 1901
Statewide Hearing Aid Center, Great Falls, Montana:
  Carol J. Hieb, letter and attachments 2328
  Robert Murphy, letter and attachments 2334
Stephens, Thomas R., Bethlehem Hearing Aid Center, letter 1967
Sunstein, James L., Airport Limousine Service Inc., letter 1882
Texas, State of, Hon. Jim Mattox, Attorney General, letter 2336
U.S. Cartographic Industry Members, Dean Hammond, Hammond, Inc., statement and attachments 2345
University Patents, Inc., F. David Lake, Jr., statement 2342
Villasenor, Josh and Karen W., Beltone Hearing Aid Service, Odessa, Texas, joint letter 1966
Volunteer Trustees of Not-For-Profit Hospitals, Robert G. Eaneman, statement 2353
Wallis, Curt, J. Michael, and Peggy, Beltone Hearing Aid Service, Odessa, Texas, joint letter 1966
Weinert, Donald G., National Society of Professional Engineers, letter 2286
Williams, Ed, Florida Chiropractic Association, Inc., letter 2162
Wise, Hon. Bob, a Representative in Congress for the State of West Virginia, and Hon. Sherwood Boehlert, a Representative in Congress from the State of New York, joint letters 2356
Witter, Randall F., Cook-Witter, Inc., letter 2153
Woodard Hearing Aid Centers, Paul E. Woodard, letter and attachment 2359
YMCA, National Board, Sam Evans, statement 1202
Young's Hearing Aid Service, G. Charles Young, letter 2361

UNRELATED BUSINESS INCOME TAX

MONDAY, JUNE 22, 1987

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, DC.

The subcommittee met, pursuant to notice, at 12 noon, in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[Press releases announcing the hearings follow:]

FOR IMMEDIATE RELEASE
FRIDAY, SEPTEMBER 12, 1986

PRESS RELEASE #25
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES SUBCOMMITTEE REVIEW OF THE UNRELATED BUSINESS INCOME TAX

The Honorable Dan Rostenkowski, Chairman of the Committee on Ways and Means, today announced that he has requested the Chairman of the Subcommittee on Oversight, the Honorable J. J. Pickle (D., Texas), to conduct a comprehensive review of the Federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code. These organizations include, among others, charitable, educational, scientific, and religious organizations; social welfare organizations; labor or agricultural organizations; trade associations; social clubs; voluntary employee benefit associations; and qualified pension plans. Further details and specific dates for hearings will be announced at a later date.

In general, current law provides for the taxation of income derived by tax-exempt organizations from any trade or business that is regularly carried on by the organization and that is not substantially related to the performance by the organization of its exempt purpose (aside from the need of the organization for funds). In addition, income derived from debt-financed property is subject to tax. This unrelated business income tax is applied at the corporate or trust tax rates, depending on the form of the organization.

Present law includes numerous modifications and exceptions to the general definition of unrelated business income, as well as special rules applicable only to certain types of tax-exempt organizations. The exceptions from taxation under present law include dividends and interest; royalties; certain rents; gains on the disposition of capital assets; income derived from certain research activities; and income derived from certain conventions, trade shows, fairs, and bingo games. In addition, the unrelated business income tax does not apply to income from a trade or business where substantially all the work is performed for the organization without compensation; where the activity is carried on primarily by certain organizations for the convenience of the organization's members, students, patients, or employees; or which consists of selling donated merchandise. Additional exceptions would be added by H.R. 3838, the Tax Reform Act of 1986.

In announcing this review, Chairman Rostenkowski stated, "The unrelated business income tax was enacted in 1950, and revised and expanded in the Tax Reform Act of 1969. With limited exceptions, there has been no comprehensive review of the unrelated business income tax rules since 1969. Since that time, there has been substantial growth in the tax-exempt sector of our economy. As of the end of 1985, the IRS Exempt Organization Master Files listed approximately 850,000 tax-exempt organizations with total revenues exceeding $300 billion a year. In recent years, exempt organizations have become more aggressive in undertaking commercial or entrepreneurial activities. For-profit businesses have complained that tax-exempt organizations are provided an unfair competitive advantage under present tax law. Indeed, this issue of unfair competition now has reached national prominence as demonstrated by the designation of this issue as a priority item during the recent National White House Conference on Small Business."

(MORE)

In light of these developments and concerns, Chairman Rostenkowski has asked the Subcommittee to examine the policy considerations underlying the appropriate tax treatment of income-producing activities of tax-exempt organizations, the impact of present-law rules on both tax-exempt organizations and for-profit businesses, as well as IRS application of, and taxpayer compliance with, the law. Detailed information is requested by the Subcommittee to develop a profile of income-producing activities and a historical survey of experiences with the unrelated business income rules. This information will assist the Subcommittee in determining whether the current rules set forth the appropriate standards for determining the taxability of the income-producing activities of tax-exempt organizations, and the effect of such activities on tax-exempt status.

The following questions set forth the Subcommittee's framework for review:

I. Profile of Tax-Exempt Organization Activities:

A. What types of income-producing activities -- whether considered "active" or "passive" -- are carried on by tax-exempt organizations, and how much revenue is produced by such activities? Do different types of tax-exempt organizations tend to engage in different types of investment, commercial, or entrepreneurial activities?

B. How and why have the type, nature, and extent of such income-producing activities changed since 1950? What are the future trends?

C. Are tax-exempt organizations and for-profit businesses competing in the same income-producing activities?

1. To what extent do tax-exempt organizations engage in income-producing activities that are being, or could be carried on, by taxable businesses?

2. To what extent do taxable businesses engage in income-producing activities that traditionally have been performed by tax-exempt organizations?

3. Has renewed concern about competition between tax-exempt and for-profit organizations arisen because tax-exempt organizations are moving into innovative revenue-raising techniques or because traditional tax-exempt organization activities have recently become profitable?

D. To what extent are tax-exempt organizations engaging in commercial activities with for-profit businesses through joint ventures, limited partnerships, or other means? Is the participation of tax-exempt organizations in such commercial ventures inconsistent with their exempt status?

E. To what extent, if any, do current income-producing activities of exempt organizations relate to Federal budget cuts or other government policies?

II. The Purpose of the Law and Its Administration by the Internal Revenue Service and the Courts:

A. What purposes do the unrelated business income tax rules serve? Are these goals being met?

B. Are the "relatedness" and "trade or business" tests appropriate and administrable? What is the relationship between the extent of an organization's related or unrelated trade or business activities and its eligibility for exempt status?

(MORE)

C. What rationales underlie the various exceptions and modifications which permit tax-exempt organizations to engage in certain income-producing activities without taxation? For example, should endowment income be exempt from tax?

D. How is the law relating to unrelated business income being interpreted? Has interpretation of the law changed over time?

E. How does the Internal Revenue Service determine whether a tax-exempt organization's activity generates unrelated business income?

F. Are the current rules unduly burdensome or unreasonably restrictive for tax-exempt organizations?

G. Do the present-law rules permit unfair competition by exempt organizations? If so, how should the rules be changed?

III. Compliance with the Unrelated Business Income Tax:

A. Does the Internal Revenue Service have an adequate, well-balanced enforcement program in this area?

B. What portion of income subject to the unrelated business income tax is reported by recipient organizations on Form 990-T?

C. Can tax-exempt organizations that do not report or mischaracterize unrelated business income be readily identified?

D. Are the Forms 990 and 990-T adequate to identify the type of income-producing activity, the degree of "relatedness" of an activity to an organization's tax-exempt purpose, and other compliance issues?

* * * *

FOR IMMEDIATE RELEASE
THURSDAY, MAY 14, 1987

PRESS RELEASE #9
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE SCHEDULING OF HEARINGS TO REVIEW THE UNRELATED BUSINESS INCOME TAX

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will conduct hearings to review the unrelated business income tax. The Subcommittee's hearings will focus on the Federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code.

The hearings will be held during the week of June 22, 1987, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m. Further details will be announced at a later date.

Background information and an outline of the scope of the Subcommittee's review are contained in Committee on Ways and Means Press Release #25, dated September 12, 1986. This information remains unchanged and should be the basis of hearing testimony presented by the public.

In announcing these hearings, Chairman Pickle stated, "The unrelated business income tax is an area of the tax laws that needs comprehensive review. The unrelated business income tax was enacted in 1950, and revised and expanded in the Tax Reform Act of 1969. With limited exceptions, there has been no comprehensive review of the unrelated business income tax rules since 1969. There are many unanswered questions about the scope and nature of tax-exempt organizations' income-producing activities, the administration of the unrelated business income tax by the Internal Revenue Service and the courts, and the extent of compliance with the law.

I recognize the extreme importance of this matter to tax-exempt organizations and for-profit businesses alike. The Subcommittee is committed to a full and fair hearing of all the issues involved. We look forward to hearing from those affected by the tax and exploring whether present law rules and underlying policy considerations are appropriate. To date, little factual or statistical data has been available to the Congress for the purpose of evaluating the effect of the unrelated business income tax."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than Wednesday, May 27, 1987, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D. C. 20515. Requests should indicate the specific issues and points the witness wishes to address, in order to facilitate scheduling. It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee staff [(202) 225-5522].

In order to assure the most productive use of the limited amount of time available, witnesses scheduled to present oral testimony are requested to briefly summarize their written statements in no more than five minutes. The full written statement will be included in the printed record. Further, witnesses scheduled to appear before the Subcommittee are required to submit 150 copies of their prepared statements to the Subcommittee on Oversight office, room 1105 Longworth House Office Building, by close of business Friday, June 5, 1987.

Deadlines for submitting requests to be heard and copies of hearing testimony will be strictly enforced. Those not complying with such requirements may submit their statements for inclusion in the printed hearing record.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting a written statement in lieu of a personal appearance should submit six (6) copies of their statements by the close of business Friday, July 17, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D. C. 20515. If those filing a written statement for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 75 additional copies for this purpose to the Subcommittee office, room 1105 Longworth House Office Building, in advance of the public hearings.

SEE ENCLOSED FORMATTING REQUIREMENTS.

*****
****

FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 3, 1987

PRESS RELEASE #10
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARING DATES TO REVIEW THE UNRELATED BUSINESS INCOME TAX

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today the dates on which the Subcommittee will conduct hearings to review the unrelated business income tax. The Subcommittee's hearings will focus on the Federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code.

The hearings will be held on Monday, June 22, 1987, beginning at 12:00 noon; Friday, June 26, 1987, beginning at 9:00 a.m.; Monday, June 29, 1987, beginning at 12:00 noon; and Tuesday, June 30, 1987, beginning at 9:00 a.m. The hearings will be held in the main Committee hearing room, 1100 Longworth House Office Building, on June 22, 26, and 29, 1987, and in B-318 Rayburn House Office Building, on June 30, 1987.

The Subcommittee expects to accommodate all requests to be heard and, again, urges that persons and organizations having a common position designate one spokesperson to represent them. Witnesses will be notified by the Subcommittee on Monday, June 8, 1987, of their scheduled appearance date and estimated appearance time.

Background information and an outline of the scope of the Subcommittee's review are contained in Committee on Ways and Means Press Release #25, dated September 12, 1986, and Subcommittee on Oversight Press Release #9, dated May 14, 1987.

* * * * *
* * *

FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 17, 1987

PRESS RELEASE #11
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES SCHEDULE CHANGES FOR HEARINGS TO REVIEW THE UNRELATED BUSINESS INCOME TAX

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today the Subcommittee's revised schedule of hearings to review the unrelated business income tax. The Subcommittee's hearings will focus on the Federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code.

An additional hearing date has been scheduled for Thursday, June 25, 1987, beginning at 9:00 a.m. In addition, the scheduled hearing for Monday, June 29, 1987, will begin at 9:30 a.m., rather than 12:00 noon. The schedule follows:

Monday, June 22, 1987	12:00 noon	1100 Longworth Bldg.
Thursday, June 25, 1987	9:00 a.m.	1100 Longworth Bldg.
Friday, June 26, 1987	9:00 a.m.	1100 Longworth Bldg.
Monday, June 29, 1987	9:30 a.m.	1100 Longworth Bldg.
Tuesday, June 30, 1987	9:00 a.m.	B-318 Rayburn Bldg.

Background information and an outline of the scope of the Subcommittee's review are contained in Committee on Ways and Means Press Release #25, dated September 12, 1986, and Subcommittee on Oversight Press Release #9, dated May 14, 1987.

* * * * *
* * *

Chairman PICKLE. The Chair will ask the committee to come to order, and we ask our guests to please take their seats.

The Subcommittee on Oversight today begins its hearings to examine the unrelated business income tax, commonly referred to as the UBIT.

This UBIT is a tax paid on income that is not substantially related to an organization's tax-exempt purpose. This tax was created in 1950, and no comprehensive review of this area has been conducted since 1969.

So these hearings are designed to explore a number of issues. We want to know what kinds of commercial activities tax-exempt organizations are engaged in. We want to know which organizations are paying the unrelated business income tax, and which ones have set up taxable subsidiaries.

We want to hear opinions on whether the law is properly structured, and we want to find out whether it is being administered effectively, and fairly.

If these questions could be answered by a telephone call to the IRS, or to Treasury, we would not need these hearings. But obviously, it cannot be handled in that manner.

What I have found, unfortunately, is that there is not much information on UBIT available from the Government. The purposes of these hearings is not to dwell on the lack of Government information, but rather, to hear from "the horse's mouth," so to speak, on exactly what is going on.

I was surprised to find out that about half of all the UBIT tax collected by IRS in 1986 came from only two tax cases. There are about 850,000 plus tax-exempt organizations but only 27,000 reported having unrelated business income. That is 3 percent. Are we to assume that 97 percent had no income-producing activities subject to the tax?

What do we know about these organizations that did not file a form 990-T? In 1985, tax-exempt organizations had total revenues of more than $300 billion.

That is a tremendous amount of money, but, even so, I do not consider the main issue here to be one of Federal tax revenue. I think the major issue is one of fairness. What should be taxed, and what should not be taxed? How should we define what is "substantially related", and is that a fair and appropriate standard?

Now, we know that there has been a tremendous growth in the number of tax-exempt organizations, and we know that more of them are relying in income-producing activities other than the traditional contributions and dues.

This has raised the question of whether this growth and diversification should be controlled or restricted. Is there a need for increased enforcement? Is there a need for legislation to tighten the rules or more clearly define the intent of Congress? Or should we just let well enough alone?

On one hand, businesses argue that the UBIT tax is not working and is permitting unfair competition. On the other hand, tax-exempt organizations argue that they are providing valuable services to their communities.

Have tax-exempt organizations intruded into the for-profit business market, or, have businesses found a profit in traditionally tax-exempt activities?

I hope we will have a spirited debate on these questions. Our goal today is to get the answers to the tax-policy question about UBIT.

We will receive testimony from the Department of the Treasury, the Internal Revenue Service, the General Accounting Office, and the Small Business Administration.

Then following the testimony of those two panels, first, we will hear from representatives of some of our larger tax-exempt organizations and then our small business groups.

I might also add that there will be five days of hearing on this subject: one today, one Thursday and Friday, and then next Monday and Tuesday, and we have well over a hundred witnesses.

[The prepared opening statement of Chairman Pickle follows:]

OPENING STATEMENT OF HON. J.J. PICKLE, CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS

The Subcommittee on Oversight will begin its first day of hearings to examine various aspects of the unrelated business income tax, commonly referred to as UBIT. The unrelated business income is a tax paid on activities of tax-exempt organizations which are "not substantially related" to an organization's tax-exempt purpose. As we will discuss today, the law provides that exempt organizations report their liability for the UBIT on an annual tax return (Form 990–T), and pay tax on such activities at the applicable corporate or trust rate. A long list of types of income and activities have been excluded from application of the tax. Present law exclusions include dividend, interest, and royalty income; income from certian research and rental activities; gains and losses on the sale or exchange of property; and, activities involving certain trade shows, fairs and conventions.

The UBIT law was enacted initially in 1950, and has since been amended. No comprehensive review of application of tax, nor its effectiveness, has been conducted since 1969.

The hearings this week and next are designed to identify who is and who should be paying the unrelated business income tax, the types of "commercial" activities in which tax-exempt organizations are engaging, whether the law is being administered effectively, and whether the application and structure of the UBI tax is correct.

If these questions could be answered by a telephone call to the IRS, we would not need these hearings. What I have found, unfortunately, is that there is not much information on UBIT available from the U.S. Government. The purpose of our hearing today, and in the days that follow, is not to dwell on the lack of Government Information currently available, but rather to hear "from the horse's mouth" what exactly is going on.

Needless to say, I am alarmed that approximately half the $57 million of UBI tax collected by IRS in 1986 is attributable to only two tax cases. Further, of the more than 840,000 tax-exempt organizations on record, only about 27,000 tax-exempt organizations reported that they had income producing activities subject to the tax. What do we know about the income producing activities of the other exempt organizations? This is not an unfair question considering that exempt organizations in 1985 had more than $300 billion in revenue.

Concerned businesses continue to argue that the UBIT law does not work fairly and is having catastrophic results. However, the Subcommittee needs to be provided with hard evidence and data about the activities that businesses consider offensive. If the law is deficient, exactly where and how should it be revised? What specific exempt organization activities create the problems? Is the competition issue more a problem of perception than reality? Is the problem fundamentally a matter of enforcement and compliance?

To summarize the competition debate I ask: Have tax-exempt organizations intruded into the for-profit business market? Or, have businesses found a profit in traditional tax-exempt organization activities? I'll leave the final debate to the witnesses.

Our goal today is to get the answers to the tax policy questions that need to be answered about UBIT. As important as what activities are being taxed, is the question of what activities should be taxed. I look forward to some active discussion in this area.

During the next two weeks, we will hear from more than a hundred witnesses. I should emphasize that the witnesses scheduled to appear before the Subcommittee represent many different points of view, and allow for a balanced, fair airing of the issues. Today we will receive testimony from the Department of the Treasury, the Internal Revenue Service, the Small Business Administration, and the General Accounting Office. Following this testimony, we will hear from representatives of some of our larger tax-exempt organizations and small business groups.

Chairman PICKLE. Our first panel today will be testimony from the U.S. Department of Treasury, Mr. O. Donaldson Chapoton, Deputy Assistant Secretary for Tax Policy, a friend of a former Deputy Assistant Secretary of Tax Policy, close friend, and we are glad to have him here.

And the Internal Revenue Service represented by the Honorable Lawrence Gibbs, the IRS Commissioner.

Let me start off, first, by welcoming both of you, and Mr. Chapoton, we will be pleased to hear your testimony first.

Now we have your testimony and it is a volume, not a report, in book form, and we do not want to cut back on your time. So we would like for you to proceed because this afternoon we want to hear testimony from you, and from the IRS, and then from the General Accounting Office, and other witnesses.

But neither are we asking you to just dwell, indeterminably, since you have about a 50-page document here, at least, we would ask you to proceed. If you follow your script, we wish you to tell us where you are, if you can, so we can follow it up here, as best we can.

So Mr. Chapoton, if you will proceed, and then we will hear from Mr. Gibbs.

STATEMENT OF O. DONALDSON CHAPOTON, DEPUTY ASSISTANT SECRETARY (TAX POLICY), U.S. DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you very much, Mr. Chairman. Rest assured I am not going to read my entire statement. We would all be here too long for me to do that.

Chairman PICKLE. It will be included.

Mr. CHAPOTON. It is a lengthy statement and is a document that we have worked on very hard over the past several months, and we think there is a great deal of information contained therein. What I would like to do is summarize the statements contained in the testimony, the written testimony, and emphasize some of the main points that we have raised in there.

What I would like to start on, though, is just to explain some background of this area of the law. The tax exemption for charitable organizations has been in the law since 1894. That was even before the Federal income tax was enacted. It was related to a general tax on the income and profits of corporations.

Over the last 70 years, or more, the income tax has been amended a number of times, and despite this long history of the tax, or perhaps because of this long history, there is very little logic, or reason, or legislative history to support a number of the reasons for the tax exemption provisions presently contained in the code.

At the same time, over this long period of time, the tax-exempt sector has grown enormously, and as we all know, it has gotten into a lot of business activities which they simply did not engage in a number of years ago.

Because of the large and diverse group of organizations that engage in these activities, the number of activities is equally diverse and equally broad. We, unfortunately, have a lack of detailed information to determine, with precision, exactly what recommendations should be made to clarify the law in the tax-exempt area.

For that reason, the primary purpose of my testimony today is going to be to identify issues that we think deserve further attention, and to examine the relevant tax-policy considerations that should be kept in mind in making these determinations.

My comments will contain several recommendations and suggestions, but these are not intended as specific legislative proposals. Rather, we would prefe that they be considered as a starting point for the debate that must ensue to reach the proper result here.

Mr. Chairman, the point you made is quite accurate, that there are an extremely large number of these organizations. My testimony contains it, but just to comment on it, there are approximately 1.2 million exempt organizations in this country today.

This includes 340,000 churches, nearly 390,000 religious organizations which are not churches, and educational, charitable and scientific organizations, and 130,000 civic leagues and social welfare organizations.

In the last 20 years, there has been a substantial growth in this nonprofit sector. During this period, the number of active tax-exempt organizations included in the IRS master file for tax-exempt organizations has more than doubled, from about 400,000 to over 850,000, currently.

It is also interesting to note that the funding for the nonprofit sector has changed and has increased somewhat in the business activity. The business activity is accounting for a greater percentage of the funding of tax-exempts.

In 1946, tax-exempts obtained approximately 59 percent of their support from business receipts, interest, dividends, rents, and the like.

In 1975, that 59 percent grew to 71 percent, and in 1983, it grew to 78 percent. So, outside income as opposed to donations and contributions is increasing as a source of funds for tax-exempts.

But unfortunately, even this information might not present exactly the correct picture, because we cannot determine—as I will get into in a moment—what portion of the moneys of the tax-exempts comes from their wholly-owned subsidiaries, or subsidiaries in which they own a controlling interest, and therefore, they control the activities of those subsidiaries as opposed to passive investments in unrelated corporations.

Let me touch, just briefly, on the historical development of the law and then I will get into more specific proposals, or specific ideas that we have reviewed. Prior to 1950, there was no specific tax on unrelated business income of tax-exempts.

Actually, the notion then was that the purpose of the money going ultimately for a tax-exempt purpose made it irrelevant to determine whether or not the source of the funds was a business activity.

But in 1950, it was determined that some tax should be imposed upon the business income of tax-exempt organizations, so the unrelated business income tax was first imposed, and it did not include churches but it did include most tax-exempt organizations, to the extent they had unrelated business income.

The legislative history of the 1950 act indicates that Congress, at that time, was concerned about unfair competition, and that was one of the main reasons for imposing the tax. Subsequent to 1950, however, the many exceptions that were in the unrelated business income tax, the fact that it did not apply to churches, and the fact that the law was amended from time to time, caused Congress to look at the law again in 1969. At that time the unrelated business income tax was expanded to include churches. It was also tightened, in many respects, again aimed at what was perceived to be unfair competition.

That brings us, really, to where we are today with the unrelated business income tax in the law. The purpose of that tax is to tax, as the law says, "Unrelated trade or business income", meaning any trade or business that is regularly carried on and is not substantially related to the performance or the purpose for which the organization is granted exempt status.

There are three specific exceptions in the UBIT—as I will refer to the unrelated business income tax—where, even if the income is unrelated, it is not subject to tax under that provision.

And that is, if all the work, or substantially all of it, is carried on by volunteers, if it is income from an activity that is carried on primarily for the convenience of its members, or if it is income derived primarily from the sale of donated merchandise.

In addition, the gross income from unrelated business is determined like any other taxable income, and so deductions are allowed against that income.

Passive income, generally, is excepted from the unrelated business income tax, and I have set forth in my testimony the specific exemptions that are included, but basically, they are what we think of as passive income. Dividends, interest, royalties, rents from real property, gains and losses from the sale of noninventory items, and things of that sort.

I think our purpose today is to consider whether this law that I have just described is working properly, whether it needs to be amended in some respects, or studied further. In doing that I think we necessarily have to look at the rationale for the tax policy that underlies the exemption from tax of tax-exempt organizations.

Unfortunately, as I have indicated, the legislative history provides little basis of the rationale over the years. The biggest segment of the exempt sector does have significant amounts of income from sources which could be considered business activities.

This could include a ballet company that charges for its tickets, or a nonprofit hospital that charges its patients. Items of that sort could be the subject of unrelated business income tax unless we, as a society, determine that it is not the type of income that ought to be taxed.

I think the basis for this exemption really ties, in many respects, to the basis—the similarity, at least, of a governmental activity. It is presumed that charities will perform functions, that governments do not perform, for the benefit of society, and that in performing these activities, they should not be taxed on them.

Nevertheless, the role of the tax-exempts should not be unlimited, and we see the basic test for determining whether income should or should not be taxed is whether public charities are performing services, or performing activities which furnish goods and services, in the quality and quantity that cannot be produced through market forces. That is, that cannot be produced in the private, for-profit sector.

One of the main questions that has, I think, caused this hearing to be called today, relates to the competition which the nonprofit sector engages in with the profit sector.

That is a difficult concept to analyze very precisely. We think undoubtedly there is going to be competition between the private sector and the nonprofit sector just so long as the nonprofit sector does engage in some business activities.

We think that so long as the nonprofit sectors' activities are very closely related to their tax-exempt purpose, this activity, this earning of income, is not considered terribly worrisome.

It is generally thought of, at least if it's closely related to its activities, that it is performing a service which cannot adequately be performed by the for-profit sector.

But as these activities get more distant from the specific tax-exempt purpose of the organization it becomes of greater concern.

In considering how tax-exempt organizations function, one question that is raised, both in the IRS review of these matters—and I think Mr. Gibbs will have further comments on this—but also in an analysis of the tax-policy rationale, is the accountability of tax-exempt organizations to someone.

I think currently the concept of accountability is really determined primarily by the IRS examinations of the tax-exempt entities to see if they are performing their tax-exempt function, if they are earning unrelated business income, and if they are, is this business income being properly reported and taxed.

I have some concern, though, whether that is a sufficient analysis, or a sufficient determination of the accountability of tax-exempt organizations, because also, as I think Mr. Gibbs will probably comment, it is difficult for the IRS to assume that burden entirely.

It is questionable whether it is a proper allocation of resources for the IRS to examine tax-exempts in cases where it is not likely to produce tax revenue, and therefore, I think we should consider whether there are other means of establishing accountability of tax-exempts, perhaps such as by further public disclosure of information, perhaps further public disclosure of the forms 990 and 990-T which are presently filed by these organizations, and perhaps some further public disclosure required by State laws.

In most States, I suppose all States, the attorney generals of the States have the responsibility of looking after nonprofit organizations, and perhaps some accountability could be obtained by further public disclosure enforced by State laws.

Let me now get into the law, and into the areas that we think require some specific study, some specific analysis. I should again emphasize that in doing this we do think we need more data, we do think we need more information.

We do not mean these as specific legislative proposals but as matters that we would like to be raised for consideration on the basis of additional information, perhaps, again, from these hearings, perhaps, again, from additional reporting requirements which we would suggest in the IRS filings.

The threshold, as I have indicated, in determining the unrelated business income tax, is the substantially related test. We have studied this test carefully. The regulations provide that "substantially related" means that the business activity of a tax-exempt organization has a substantial causal relationship to the accomplishment of the organization's exempt purpose.

This activity, therefore, must contribute importantly to the accomplishment of the exempt purpose of the organization.

We have studied that concept to see if another test, or a more precise test, might be prescribed so as to make the test easier to apply.

Quite frankly, our study has led us to conclude that the test is probably a good one, that it is difficult to improve upon it. In practice, however, we think it is not being interpreted by the courts quite as it might be, and therefore, we think some additional study, including the information elicited at these hearings, would indicate if there is some way to broaden this test.

We think some courts, for example, have analyzed the regulatory requirement that the activity contribute importantly to the organization's exempt purpose, as to be satisfied where the activity contributes simply in some way to that purpose.

We do not think that is what the test says, we do not think that is what it means, and we think that it needs to be tightened up in that sense, if the test is to remain as it currently is on the books.

Chairman PICKLE. Mr. Secretary, let me interrupt you. At what point are you making this recommendation now? Do you have a page reference, when you are talking about "substantially related"?

Mr. CHAPOTON. Mr. Chairman, I am sorry, I am reading from a different copy than the written testimony.

Chairman PICKLE. I want to further identify your specific recommendations or suggestions.

Mr. CHAPOTON. It begins on page 15, and then the specific recommendations are at the top of page 17.

Chairman PICKLE. All right. I understand. Thank you.

Mr. CHAPOTON. As we say there, in summary, we believe that the test has conceptual merit but we are concerned about its inherent generality, and that it is a source of administrative difficulty. We believe more detailed information concerning the sources of revenues that exempt organizations derive would be helpful in determining whether this test needs to be amended, or whether stricter application of it, as presently written, would produce the right result.

I would like to turn, now, to the exceptions to the definition of "unrelated business" and I will touch on those only very briefly. There are three specific statutory exceptions.

The first is where a business is operated by volunteers the business income is not to tax. Our study has indicated that there is justification for this exception and we think it should be retained in the law, but, at the same time, we have a question about whether it should be unlimited in scope, and therefore, before we propose anything specific, we hope to find out more information on just how that test is being applied.

The second exception is business activities engaged in for the convenience of the members of the organization. It is extended to convenience of members, students, patients, officers or employees, and things of that nature. This test apparently was originally put in the law to be sure that dining rooms, dining halls, dormitories, hospital cafeterias, and things of that nature would not be subject to tax when they were engaged in by the organization.

We obviously think those types of activities deserve some exception; however, we are afraid the convenience test may be too broad. We think each of those examples that I have just given would qualify for exemption under the relatedness test.

And therefore, again, while we are not able to say that the convenience test in no circumstances should apply, we think it requires close study because we have considerable question whether it is too broad, and whether it is simply used as a means of not justifying relatedness, or some other statutory criteria for qualifying for exemption. Thus the convenience test in itself may be too broad.

The third specific exemption relates to donated property. We have looked at that. We simply think the test is one which does make sense. It was primarily put in the law to exempt sales by charitable organizations, rummage sales, and things of that sort.

While the test probably could be expanded, and while exempt thrift shops undoubtedly compete in some respects with taxable thrift shops, we think there is very little tax-revenue there because the donated property would probably have a high-tax basis. Thus probably, in this area of the law, there is either no abuse, or no significant abuse, caused by the contributed property exception.

Turning now to the computation of the unrelated business income tax, there are a couple of areas of concern. These include the method of allocating expenses in determining how unrelated business income is calculated, the specific deduction allowed in the tax law, and the fragmentation rule.

The allocation of expenses is a very complicated area, and one which we have studied, and worried whether it is being properly administered.

Basically, the question is where an organization such as a university operates a football stadium for its own football teams, but on some occasions allows that football stadium to be leased out for, say, a professional football game. How should the expenses relating to the operation of the football stadium be allocated to the income which is derived from the leasing of that stadium to a professional football team?

A case of first impression, and the only significant case in this area, was decided in 1984 by the Second Circuit. That is the *Rensselaer Polytechnic Institute* case cited in our testimony. In that case the IRS argued that the tax-exempt organization was using the wrong allocation method. The organization was basing its allocation on the concept of comparing the number of hours used for the exempt purpose, that is, the school's use of the activity, and the number of hours used in leasing activities. In this case, I think it was leasing for public ice skating.

Without going into the details of that case, we think that case used the wrong allocation method. We think that a strong argument could be made that allocations of this sort should be related only to direct expenses incurred by the entity in conducting the nonexempt purpose of the organization, the commercial purpose. Thus only the direct expenses it incurs in the commercial activity should be allocated. But we think that is a test which is perhaps unfair because, while we say another argument could be made in that direction, it is perhaps unfair because in many cases tax-exempts must take into account their commercial use of a facility when they are constructing it in the first place. An allocation method such as I described would adversely impact the ability of tax-exempt organizations to consider commercial business purposes in costing and building these facilities.

So we think a more appropriate method would be to require that the income attributable to the unrelated business be taxed on essentially the same terms as any other commercial activities, by requiring an allocation method based on total available time, not strictly on the basis, as in the *Rensselaer* case, of the total time which is used by the tax-exempt versus the commercial purpose.

We think that would be a fair test. We think it would accomplish the purpose of this allocation method, and we would like the Committee to consider that as a possibility.

Under current law, there is a specific deduction of $1,000 allowed against unrelated business taxable income. Just suffice it to say, as we point out in our testimony, that that has been in the law a number of years, I think since 1950, when the unrelated business income tax was first enacted. We think some adjustment to this is appropriate, and we would suggest that a sort of de minimis rule on unrelated business taxable income be increased to $5,000.

Next in the application of the tax is the fragmentation rule which we go into in our testimony. That is a rule that allows the taxation of an unrelated activity carried on by a tax-exempt organization in the context of a larger aggregate of activities—such as a museum gift shop, for example. We think museum gift shops have been shown to be, in many cases, related to the tax-exempt activity of the museum, but where that museum gift shop sells T-shirts or toys, or something that is unrelated, this fragmentation rule requires the organization to pay tax on the income from activities which are unrelated within this exempt activity.

We think that rule, while it is difficult to administer, is a practical rule, and we see, really, no practical alternative to allowing the fragmentation rule to continue to apply. Mr. Gibbs may have some thoughts on how that rule could be more logically defined, or be administered better.

I would like next to turn to the spot in my testimony on unrelated business as carried on by subsidiaries. There are really two important issues here, and that is whether, when activities are conducted in subsidiaries, whether the treatment of rents and royalties, interest, annuities, things of that sort, is being properly handled. And second, when activities are transferred from the tax-exempt entity to a subsidiary, whether the primary purpose test is being properly administered.

I will not dwell on this too much. Let me just say that right now, a tax-exempt entity, if it engages in a certain activity, as we have an example in our testimony of manufacturing sweatshirts embossed with the organization's logo, and assuming it is not considered related to its tax-exempt activity, then it is very clear that that is an unrelated business which is subject to tax.

However, if it drops that activity into a subsidiary which has a minority interest held by another party, so that it is not, under current law, a controlled subsidiary, it could then take back from that subsidiary a royalty for the sale of those T-shirts. It could also charge the subsidiary rent for the use of a building, and interest on loans, and things of that sort; and those royalties, interest, and rent, would not be subject to tax.

We think that the royalty, interest and rent exception is a proper one in proper cases, but where these payments are received from a controlled subsidiary we think it is not proper and requires reexamination.

The current test for a controlled subsidiary relates to 80 percent. A subsidiary is deemed controlled if it is 80 percent owned by the parent corporation, but that test is so precise that it can be easily avoided by changing the voting stock, and things of that nature, of the subsidiary.

We would like to see that test changed to a more general 50 percent control, or more than 50 percent test. That if the tax-exempt entity controls the subsidiary directly, or indirectly, by more than 50 percent, then it should be considered a controlled subsidiary.

Likewise, we think that the primary purpose test should be analyzed in this same context. Right now a tax-exempt entity, if it engages in too much unrelated business activity will not continue to be tax exempt, if it deemed that its primary purpose is to engage in the taxable activity, rather than the tax-exempt activity, but this can be avoided by dropping that taxable activity into a subsidiary. We think that needs reexamination.

Turning now to passive income. The definition of unrelated business income excludes, as I have said, dividends, interest, annuities, royalties, and things of that sort.

We have examined that concept, and we think that generally, with the qualifications that I will mention, that it should be preserved.

We think that while some questions perhaps have been raised about it, that we see that the passive income activities of a tax-exempt organization are not subject to abuse, and not something that generally should be attacked in most cases.

For example, I turn specifically to public charities. We think that the earning of passive income by public charities that is used to support the tax-exempt purposes of the public charities, which is all of that income, is appropriately exempt from tax. While we have some concerns about the definition of passive income, as I will indicate, we think that the exemption for such income earned by public charities is appropriate.

Mr. CHAPOTON. We have a little concern in that area. Under current law, social welfare organizations are taxed on their passive income to the extent it is expended on political activities. But other than the expending of those funds on political activities, their passive income is not subject to tax.

Chairman PICKLE. Mr. Secretary, may I interrupt? When you say that the passive income should be taxed with reference to social welfare organizations, will you identify the type of groups you are referring to as social welfare organizations?

Mr. CHAPOTON. Mr. Chairman, it is generally organizations which are quite similar to 501(c)(3) organizations that engage in religious, charitable purposes. However, the exemption is contained under section 501(c)(4) of the Tax Code and being under 501(c)(4), contributions to those organizations are not tax deductible and those organizations are allowed to engage in political activities and lobbying activities. Our concern is that where they earn passive income and some of that income is used for the other purposes which they are permitted to engage in, such as lobbying or other activities, we have difficulty seeing whether that passive income in those circumstances should be exempt from tax.

Chairman PICKLE. Well, I am trying to identify which type of organizations you are talking about. Is it all 501(c)(4)s?

Mr. CHAPOTON. Any 501(c)(4) would fall in that category. There are some that are set up for research, for educational activities, but in connection with engaging in those activities, they do engage in legislative and political activities. It appears that that is the primary difference between those two although not the exclusive difference because they can engage in some other activities not permitted of 501(c)(3) organizations.

Mr. FRENZEL. Are you saying tax it all then?

Mr. CHAPOTON. No, Mr. Frenzel. We are saying that to the extent that passive income is not permanently set aside for tax exempt purposes, religious, charitable, and that sort of thing, and it is devoted to other noncharitable activities, consideration should be given to subjecting that kind of income to tax. That is really just an extension of present law, you understand, because right now, to the extent such organizations expend these passive income funds on political activities, they are subject to tax.

We get in some of this same rationale on the next point, which is labor unions and trade associations. The rationale for the exemption of passive income in that area is a little more difficult to define but it appears to be something of a flow-through concept where a trade association, for example, charges dues of its members. Those dues would generally give rise to a business deduction because the activities engaged in by the organization would be a deductible expenditure if engaged in by the member itself. That is not probably true in most cases with respect to labor unions since their employees only obtain a deduction if they itemize and, of course, under the 1986 act, they can get that deduction only if the expenditure and other similar expenditures exceed 2 percent of their gross income.

For those reasons, we think that some examination of the exemption of passive income of those organizations might be considered. This is a complex area of the law and there are circumstances under which it might be considered that those exemptions for passive income might be justified. But a pure tax policy analysis, the rationale which is outlined in the testimony, would indicate that some examination of that exemption of that income should be considered.

Turning now to specific types of passive income, the one that I would like to touch on, is royalties. The royalty area is a very broad area, it is somewhat broadly defined, and it is somewhat hazy under the present law. As I have indicated about the licensing of activities where, for example, a logo on a T-shirt that might be sold, that can be a royalty and would be tax exempt if that activity is performed by another organization and the tax exempt entity simply gets a royalty for allowing its logo to be used. On the other hand, the law is specific that if an organization exploits its goodwill or its name, that type of net income is subject to tax as unrelated business income. So we think there is a little inconsistency there and we think that the broad definition of royalties might bear some scrutiny and should perhaps be tightened up.

We think, for example, that royalties might be defined to exclude amounts measured by net profits. As I point out in my testimony, such a restriction on the definition of royalties for purposes of the passive income exception would be consistent with the restrictions imposed on the definition of rents. In addition, consideration should be given to excluding from the definition of royalties situations where an exempt organization is exploiting goodwill, as I have just mentioned.

Turning now to research activities. Under present law many organizations are generally not taxed on their income from research activities. There are a number of specific exemptions for universities and others on all of their research activities, and we think by and large these exemptions are justified. Our concern in this area is that the term research is not precisely defined in the statutes, in the regulations, or in the case law. The regulations provide that research includes both basic and applied research but does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations. That, however, does not precisely limit just what might be defined to be research that is qualified for the exemption.

We think it is appropriate for the Federal Government to provide incentives for research and we have testified to that on several occasions in the areas of research and development for profit-making entities. And we think that consistent with this objective of providing incentives for research activities that are not adequately supported by the private sector and for fostering the advancement of knowledge, the tax exemption provisions for research activities should identify the type of research activity that we wish to encourage and should provide requirements to ensure the public benefits from such tax exempt research. For this reason, we think some additional guidance should be provided in the tax law as to the types of applied, purely commercial, activities that do not merit tax exemption.

In addition, we would suggest that there be specific requirements concerning public dissemination of research results. Such a requirement would ensure that the public benefits from the research encouraged by the tax exemption. Let me emphasize in raising these issues, we recognize that the exempt sector is itself concerned with this area, that the scientific and educational purposes of its exempt organizations may be undercut by the commercial potential of research activities. Thus, we encourage the participation of these organizations and they have indicated they want to participate with us in the development of the appropriate standards for the conduct of tax exempt research activities.

The final area that I would like to touch on briefly is the rather complicated area of joint ventures. There are really two problems here when tax exempt entities get into joint ventures with commercial activities. The first is the allocation of the taxable income and tax deductions. This is not unlike the general problem we have in the tax area where activities are engaged in and allocations are made to partners that can better benefit from tax deductions. In this area, obviously, the tax exempt entity needs no tax deductions and, therefore, there is an incentive to shift taxable income to the tax exempt entity and the deductions to the commercial entities. In light of this concern, several rules have been engrafted in the law to provide that where a tax exempt entity is a partner in a joint venture, that some of the benefits of the law, such as investment tax credit benefits and the accelerated depreciation provisions, do not apply to the partnership so that the allocation problem is lessened.

My testimony does point out, however, that even with those rules in the law, that since there are tax benefits in these transactions and since the tax exempt entities cannot use them, that there is still some concern. We think this area still needs to be considered further—to see whether the allocation rules are being improperly used to go around the purpose which these provisions in the law were designed to accomplish. That is, not to allow tax deductions generated by the activities of tax exempt entities to go to commercial enterprises.

Secondly, the question raised with joint ventures is the very basic one of when a tax exempt entity performs an exempt function through a partnership, is this inconsistent with the basic purpose of the tax exemption? Can the tax exempt entity actually perform an exempt function through a partnership in which it has a commercial or a profitmaking partner and can it be said that in so doing, the tax exempt requirement that none of the profits of the tax exempt entity inure to the benefit of private parties is met? We think that is a difficult question. We point out in the testimony that it has apparently been addressed only by one case, the *Plumstead Theatre Society* case. In that case, the court held that despite the fact that there were commercial partners to a theatre production, that nevertheless, the theatre production was a tax exempt function, and the tax exempt purpose of the entity was not undermined by its having the commercial partners. We would point out that that case relied heavily on the particular facts before the court. We do not think it represents a broad determination that a commercial partner of a tax exempt entity is okay in every circumstance. We do have some concern that this area should be closely scrutinized and limited. We recognize that commercial enterprises can lend money, that there can be debt running from a tax-exempt entity to commercial organizations. But we think where the commercial organization actually gets into a partnership with the tax exempt entity, it raises the question of whether that entity is performing an activity on some basis other than strictly for charitable purposes.

The IRS, when it audits these organizations, currently tries to determine whether the partnership is serving a strictly charitable purpose or whether it is also serving a commercial purpose. If it is primarily serving a commercial purpose, would determine that the tax exemption is not valid. We think that would be the only solution under present law. We think also that perhaps that solution of denying the tax exemption may be too harsh, that perhaps some consideration should be given to taxing that income rather than just determining that the entity loses its tax exemption. But basically, we think that is an area that requires some further consideration.

Mr. Chairman, that concludes my remarks on my testimony. As I have said, we think that these areas require more data, much of which we hope will be elicited at these hearings; some of which we would recommend, and we do point out in our testimony, can be raised by expanded reporting in the IRS forms. Based on that information, we may be able to determine more precisely what areas need to be addressed. Thank you.

[The prepared statement follows:]

For Release Upon Delivery
Expected at 12:00 P.M., E.D.T.
June 22, 1987

STATEMENT OF
O. DONALDSON CHAPOTON
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the Treasury Department's views concerning the appropriate tax treatment of income-producing activities of exempt organizations.

The exemption of charitable, religious, and educational organizations from tax has been a part of federal law since 1894 when the first federal act imposing a general tax on the income and profits of corporations was enacted. Many other tax exemption provisions, including those for labor unions, trade associations, and social clubs, were enacted over seventy years ago. Despite, or perhaps because of, the long history of tax exemptions in the federal income tax law, there is little guidance in the legislative record as to the rationale for exempting particular organizations from tax. At the time of the early income tax statutes, however, most exempt organizations were supported primarily by donations or were small mutual benefit organizations. Notions of taxable income were not easily applicable to their activities, distinguishing them from the for-profit businesses that Congress intended to tax.

Over the years, the exempt sector has grown enormously in both size and diversity. Moreover, many exempt organizations have come gradually to derive much or all of their income from sources other than donations. These changes have not only increased the importance of tax exemption to the exempt sector, but have also tended to blur the historical differences in activities and funding between exempt and taxable organizations.

As more fully explained below, on two previous occasions, Congress has addressed the taxation of income-producing activities of exempt organizations in a comprehensive manner. In 1950, largely in response to concerns about unfair competition between exempt organizations and taxable businesses, Congress enacted the unrelated business income tax ("UBIT"). In 1969, Congress revisited the area and expanded application of the UBIT.

In the 1980's, the income-producing activities of exempt organizations have again become matters of concern. The small business community has complained that current rules are insufficient to protect them from unfair competition. Others have questioned the rationale for the exemption of certain activities under current law. In addition, Congress has addressed several specific issues involving income-producing activities of exempt organizations, including the scope of the debt-financed property rules, leasing arrangements with taxable organizations, trade shows, the sale and rental of mailing lists, and the sale of low cost articles in connection with fundraising activities.

The subject matter of these hearings affects a large and diverse group of organizations that engage in an equally broad range of activities. In many instances, the lack of detailed information about the exempt sector prevents us from fully evaluating changes that may appear appropriate from a purely theoretical or conceptual standpoint. Accordingly, the primary purpose of my testimony today is to identify issues deserving further attention and to examine the relevant tax policy considerations. Although my testimony contains several recommendations and suggestions, these are intended not as specific legislative proposals, but as a starting point for further debate.

I will first briefly describe the size, activities and sources of funding of the exempt sector. Next, I will describe the historical development of the tax law affecting exempt organizations, and discuss the tax policy considerations that have affected this development and remain relevant today. Finally, I will examine more specifically the provisions of current law.

Although I should again emphasize the need for additional information before specific proposals can be put forward, allow me first to summarize our initial observations and recommendations.

1. With respect to business activities of exempt organizations, the Treasury Department believes the current standard of a substantial relationship to an organization's exempt purpose has conceptual merit as the basis for granting exemption from tax. We are concerned, however, with administrative and interpretative problems this standard has created. Although we do not propose changes in the "substantially related" standard, we do recommend more detailed reporting as a means of improving enforcement and compliance and of providing a basis for further review of the adequacy of the standard.

2. With respect to the existing exceptions from the "substantially related" standard, we suggest that the scope of the exemptions for businesses operated by volunteers or for the convenience of students, patients and others should be reexamined. We are concerned that these provisions may extend to activities not meriting exemption and, at least in their current form, cannot be justified on grounds of administrative convenience. Although similar conceptual questions might be raised about the provision exempting sales of donated property, in practice, we believe the exception operates appropriately.

3. With respect to the computation of the tax on unrelated business income, we suggest that the rules for allocation of expenses be clarified to reflect the appropriate relationship between an organization's exempt functions and unrelated activities. In addition, we support retention of the "fragmentation rule" and an increase in the specific deduction from unrelated business income from $1,000 to $5,000.

4. For purposes of characterizing otherwise tax-exempt passive income from subsidiaries as taxable, we suggest that the definition of a controlled subsidiary be broadened to include subsidiaries in which an exempt organization has more than a 50 percent interest in stock value or voting power. In addition, for purposes of determining whether the primary purpose of an organization is the conduct of an exempt function, we suggest that consideration be given to aggregating the activities of an exempt organization and its subsidiaries in appropriate cases.

5. With respect to passive investment income, we suggest that such income should continue to be exempt in the case of public charities, but should be taxable to social welfare organizations unless permanently set aside for charitable purposes. The treatment of passive income of labor unions and trade associations requires further study. In addition, we suggest that the exclusion for royalties should be narrowed to prevent avoidance of the tax on unrelated business income in certain circumstances.

6. With respect to the exclusions from tax for income derived from certain research activities, we believe additional attention should be given to the definition of research and to requirements for public dissemination of the results of research.

7. With respect to joint venture activities of exempt organizations, we are concerned that current restrictions on partnership allocations between taxable and tax-exempt partners may not be adequate to prevent abuse. In addition, we have serious reservations whether current law is adequate to deal with issues raised by partnerships formed to conduct exempt activities of tax-exempt organizations.

I. Background

A. General Description of Tax-Exempt Organizations

At the outset, it is useful to note that there is a distinction between nonprofit organizations and tax-exempt organizations. A nonprofit organization is an organization which is prohibited, generally by its organizational documents or state law, from distributing profits or net earnings to individuals who exercise control over it, such as its directors, officers or members. A nonprofit organization is not prohibited from earning a profit but, rather, is prohibited from distributing its profits to individuals in their private capacity.

Although most nonprofit organizations are exempt from federal income tax, the Internal Revenue Code (the "Code") does not by its terms grant tax-exempt status to all nonprofit organizations. Instead, the Code exempts from tax a diverse group of organizations, including religious, charitable, scientific and educational organizations; social welfare organizations; labor and agricultural organizations; business leagues; social clubs and many others. (Figure 1). Certain of these organizations, primarily religious, charitable, scientific and educational organizations described in section 501(c)(3) of the Code, are not only exempt from tax but are also eligible to receive tax deductible contributions.

The Code does not prohibit tax-exempt organizations (other than private foundations) from engaging in business activities for profit. If such business activities are related to the tax-exempt purpose of the organization, such as the sale by a museum of reproductions of its art collection, any profit from such business is exempt from tax. If such a business is unrelated to the exempt purpose of the organization, however, such as the operation of a manufacturing facility by a university, any profits from the unrelated business are subject to income tax, generally to the same extent as the profits of a taxable business. The fact that an organization is required to pay tax on its unrelated business income does not, in general, affect the organization's tax-exempt status. Nonetheless, if the operation of an unrelated business becomes the primary purpose of a tax-exempt organization, and its exempt function becomes a secondary purpose, the organization will cease to qualify for tax exemption under the Code.

B. Size of Exempt Sector

Tax-exempt organizations make up a large, diverse and growing sector of the U.S. economy. Currently, there are approximately 1.2 million exempt organizations, including 340,000 churches exempt under section 501(c)(3); nearly 390,000 religious (other than churches), educational, charitable and scientific organizations exempt under section 501(c)(3); 130,000 civic leagues and social welfare organizations exempt under section 501(c)(4); and 355,000 mutual benefit organizations such as labor unions, chambers of commerce, mutual insurance companies, organizations of war veterans, and cemetery companies, also exempt under section 501(c).

In the last 20 years, there has been substantial growth in the nonprofit sector. During this period, the number of active tax-exempt organizations included in the Internal Revenue Service Master File ("IRS Master File")[1] more than doubled, from about 410,000 in 1968 to about 866,000 currently.

C. Economic Activity

A significant fraction of U.S. economic activity occurs in the exempt sector. The Bureau of Economic Analysis estimated that current operating expenditures of nonprofit organizations totaled $239 billion in 1985, or six percent of GNP. In 1984, employees of nonprofit organizations (both paid and volunteer) accounted for ten percent of total hours worked in the U.S. economy, and paid employees of nonprofit organizations accounted for six percent of total hours worked by paid employees.

---

[1] The IRS Master File of Tax-Exempt Organizations is a compilation of all organizations which have applied to the Internal Revenue Service for tax exemption and been granted tax exemption. Since churches are not required to apply for tax exemption, most do not do so, and very few are listed on the IRS Master File. Of the 1.2 million estimated tax-exempt organizations referred to in the text, 866,000 are active tax-exempt organizations reported on the IRS Master File and 340,000 are churches that are not reported on the IRS Master File.

Much of the economic activity of the nonprofit sector is made up of public charities and social welfare organizations that provide health, education or research services. In 1984, 47 percent of current operating expenditures of nonprofits were accounted for by health service organizations, and 22 percent by educational and research organizations. In turn, hospitals accounted for the bulk of economic activity in the nonprofit health service sector, and private elementary and secondary schools and private colleges and universities accounted for the bulk of economic activity in the nonprofit education and research sector. In contrast, the broad range of mutual benefit organizations exempt under provisions other than section 501(c)(3) and section 501(c)(4) accounted for only 10 percent of current operating expenditures of all nonprofits in 1984.

D. Funding for the Nonprofit Sector

Nonprofit organizations finance their activities through a number of sources: government grants, private donations, fees for services, operation of businesses, and investments yielding income such as interest, dividends, rent, or royalties. The relative reliance on these different revenue sources differs greatly among subsectors of the nonprofit community. For example, while religious organizations rely mainly on private contributions, health service organizations rely on fees and charges for most of their funding, and social service organizations rely most heavily on government grants. (Table 1).

The proportion of revenue derived from various sources also varies with the size of nonprofit organizations. For public charities in 1983 (section 501(c)(3) organizations that are not private foundations), the greater the asset size of the organization, the lesser its reliance on government grants or private contributions, and the greater its reliance on fees and charges and other revenue sources. (Table 2).

There is some evidence that nonprofits have increased their reliance on income-producing or commercial activities in recent years. IRS Master File data show that, in 1946, organizations exempt under section 501(c)(3) obtained 59 percent of their support from business receipts, interest, dividends, rents, royalties, sales of assets and miscellaneous sources other than government grants, private contributions, dues and assessments; 71 percent from such sources in 1975; and 78 percent in 1983.

For a number of reasons, however, the available IRS data do not give a definitive picture of nonprofit funding trends. First, requirements for filing Form 990, the information return filed by tax-exempt organizations, have changed over time, and the form has been subject to reporting and coding problems. Specifically, because Form 990 is an information return that does not result in tax liability, improper and erroneous information is reported more frequently than on forms that require computation of tax liability. Coding problems result from the lack of detailed statistical tests to check for reporting accuracy. Second, unrelated business income is reported on a separate form, Form

990-T, income from for-profit subsidiaries of nonprofit organizations is reported on Form 1120, the corporate income tax return, and income from partnerships is reported on Form 1065. Each of these forms would need to be matched with the Form 990 of the tax-exempt entity in order to obtain a comprehensive picture of the organization's commercial activity.

Survey data from organizations such as the Urban Institute, Partners for Livable Places, the Rockefeller Brothers Fund, and the National Assembly provide supporting evidence of a trend toward increasing commercial activity by nonprofits.

E. The Unrelated Business Income Tax (UBIT)

As noted above, tax-exempt organizations are required to pay income taxes on their unrelated business income. In fiscal year 1985, approximately 24,000 nonprofits, or three percent of all tax-exempt organizations on the IRS Master File of Exempt Organizations, filed Form 990-T in order to report unrelated business income tax liability. In fiscal year 1986, the number of exempt organizations filing Form 990-T increased to over 32,000. The amount of unrelated business tax revenue also increased, from about $30 million in fiscal year 1985 to $53 million in fiscal year 1986.

Data for 1984 indicate that most unrelated businesses have a small amount of gross unrelated business income. Only 18 of the 25,000 nonprofits filing in 1984 reported unrelated business income over $3 million, 56 reported unrelated business income between $1 million and $3 million, and 1,412 reported unrelated business income between $100,000 and $1 million. In addition, less than one third of the 25,000 nonprofits reporting unrelated business income had positive taxable income, and were therefore subject to tax.

The amount of tax reported on Form 990-T, however, does not present a complete picture of tax paid by exempt organizations on unrelated businesses. Many exempt organizations operate unrelated businesses in taxable subsidiaries which file corporate income tax returns. Under current reporting requirements, it is not possible to identify the returns of taxable corporations owned by exempt organizations or to correlate such returns with those of their parents. Thus, no data are available with respect to the amount of tax paid by subsidiaries of exempt organizations.

II. Current Law

A. Historical Development

Prior to 1950, the law was unclear as to the taxation of unrelated business activities of tax-exempt organizations. Under the "destination of income" rule, the majority of courts had held that a tax-exempt organization did not lose its tax exemption by virtue of the conduct of an unrelated business so long as the profits from the business were dedicated to charitable purposes.

In fact, a "feeder" organization that engaged exclusively in commercial, non-exempt activities was treated as exempt from tax so long as all the profits from the organization were distributed to an affiliated charitable organization. The majority view was thus that the destination of income, not its source, was the appropriate test for tax exemption. Because of the liberality of the destination of income rule, prior to 1950 a number of charitable organizations carried on unrelated businesses -- businesses that often competed directly with taxable companies.

In 1950, Congress responded to the operation by exempt organizations of unrelated businesses by enacting a tax on such organizations' unrelated business income. The legislative history of the Revenue Act of 1950 indicates that Congress was primarily concerned with the issue of "unfair competition." Both the House and Senate reports state that:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [section 501(c)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemptions to buy an ordinary business. That is, they have acquired the business with little or no investment on their own part and paid for it in installments out of subsequent earnings -- a procedure which usually could not be followed if the business were taxable.

As part of the Revenue Act of 1950, Congress also enacted the "feeder organization" provision, which provides that an organization carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to another exempt organization.

In addition to directly operating a commercial enterprise, some tax-exempt organizations engaged in a transaction which became popular during the late 1940s -- the "sale and lease-back" of a taxable business to an exempt organization. In such transactions, a charitable organization would acquire a property (such as real estate) from a business, often borrowing to finance the entire acquisition, and would then lease the property back to the seller under a long-term lease. The result of the transaction was that the seller received capital for use in its business, the seller's taxable income was substantially reduced by the deductible rent, and the charity received the difference between the rental payments and its loan amortization payments, with little or no money down.

The House and Senate reports identified three principal objections to sale and lease-back arrangements. First, the tax-exempt organization was trading on its exemption because the only contribution it made to the sale and lease-back was its tax exemption. Second, the lease-back transactions, if unchecked, would result in tax-exempt entities owning the bulk of the commercial and industrial real estate in the country. Third, the exempt organization that entered into the sale and lease-back and either paid an above-market price for the property, or charged below-market rent for the use of the property, had in effect sold part of its tax exemption. In response to these objections, Congress imposed the tax on unrelated business income on income from the long-term rental of debt-financed real property and personal property leased in connection with it.

Notwithstanding the changes made by the Revenue Act of 1950, many tax-exempt organizations continued to engage in unrelated commercial activities. Such activities were permissible under the law because first, a number of tax-exempt organizations such as churches, social clubs, and fraternal beneficiary societies were not subject to the tax on unrelated business income and second, because the tax on rental income from debt-financed real property did not apply to leases of five years or less. The tax on debt-financed real property was avoided by so-called Clay Brown transactions -- "bootstrap acquisitions" similar to the sale and lease-back transactions described earlier.2/

In response to the continued involvement of charitable organizations in unrelated businesses, Congress in 1969 revisited this area of the law and made several significant changes. First, the rules regarding debt-financed property were expanded to include all debt-financed property unrelated to the exempt purpose of the organization, with no exception for short-term leases. Second, the tax on unrelated business income was expanded to apply to all exempt organizations, except certain U.S. instrumentalities created and expressly granted tax-exemption by a specific Act of Congress. Third, the investment income of social clubs and voluntary employees' beneficiary associations was subjected to tax, based on the rationale that an exemption for investment income constituted an unwarranted subsidy of recreational or personal activities. Fourth, any rent, interest or royalties paid by an 80-percent controlled subsidiary to a tax-exempt parent was included in unrelated business taxable income of the parent in an amount reflecting the portion of the subsidiary's income that would be unrelated business income if earned directly by the tax-exempt parent organization. The controlled subsidiary rule was imposed to discourage charitable organizations from "renting" part of their physical plants to taxable subsidiaries, thereby reducing or eliminating the taxable income of the subsidiaries. And fifth, Congress clarified the definition of the term "trade or business" to include activities carried on within a larger aggregate of similar activities. Thus, the sale of advertising in a magazine published by an exempt organization could be treated as an unrelated business, even though publication of the magazine was the organization's exempt function.

2/ The transactions were named after the Supreme Court case that refused to recharacterize the transaction at issue and upheld the taxpayer's claimed tax benefits. Clay Brown v. U.S., 380 U.S. 563 (1965).

Each of the changes made by the Tax Reform Act of 1969 had the effect of tightening the rules with respect to the unrelated business activities of charitable organizations, helping to ensure that such organizations paid tax on income from business activities unrelated to the purpose for which they were granted tax exemption.

During the early 1980's, a number of charitable organizations again became involved in leasing transactions with taxable entities, although with a different twist from the sale and lease-back transactions described earlier. Due to the investment tax credit and accelerated depreciation, certain types of property were effectively subject to a negative rate of tax, generating credits or losses that would offset income from the other investments. Because tax-exempt organizations could not benefit from these tax incentives directly, a number of exempt organizations, including schools, city governments, federal agencies, and foreign governments, sold part of their assets to taxable businesses that could make use of the tax incentives and would then lease the property back on a long-term basis. As part of the Tax Reform Act of 1984, Congress sought to discourage such transactions by providing that property used by a tax-exempt entity (including foreign and domestic governments) is not eligible for tax incentives such as the investment tax credit and accelerated depreciation.

Subsequent to the 1969 Act, exceptions were created to the debt-financed property rule for certain real estate investments. In 1980, with respect to pension trusts, in 1984 with respect to educational institutions, and in 1986 with respect to real property title holding companies, the general rule was modified to exclude from the debt-financed property rules the acquisition of real estate with debt so long as certain requirements were met.

B. Structure of the Unrelated Business Income Tax

In general, the UBIT is imposed on the unrelated business taxable income ("UBTI") of organizations that are otherwise exempt from tax under Code section 501(a). Tax-exempt trusts are taxed at individual tax rates and all other exempt organizations are taxed at corporate rates.

The term "unrelated trade or business" means any trade or business that is regularly carried on and is not substantially related, aside from the need of the organization for funds, to the performance of the purpose for which the organization was granted exempt status.

Specifically excluded from the term "unrelated trade or business" is any trade or business (1) in which substantially all the work is performed by volunteers; (2) which is carried on by a section 501(c)(3) organization or a state or city college or university primarily for the convenience of its members, students, patients, officers, or employees; or (3) which is the selling of donated merchandise. Certain trade show and similar activities are also specifically excluded, as are services furnished by certain cooperative hospital service organizations, the rental of telephone poles by cooperative telephone or electric companies, the rental of mailing lists to certain other exempt organizations, and the distribution of low-cost articles incidental to soliciting charitable contributions. Conducting bingo games is also specifically excluded so long as bingo is legal under state law and is not ordinarily conducted on a commercial basis.

UBTI is defined as the gross income derived from any unrelated trade or business less deductions directly connected with the carrying on of such trade or business, subject to certain modifications. Among the most significant of the modifications are the following:

1. All dividends, interest, payments with respect to loans of securities, and annuities are excluded.

2. Royalties (including overriding royalties), whether measured by production or by gross or taxable income, are excluded.

3. Rent from real property, and rents from personal property leased with real property if the rents attributable to the personal property are only an incidental amount of the total rents received or accrued under the lease, are excluded. If more than 50 percent of the rent under a lease is attributable to personal property, then none of the rent, whether attributable to the real property or the personal property, qualifies for the exclusion. In addition, rent does not qualify for the exclusion if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage of receipts or sales).

4. All gains or losses from the sale, exchange or other disposition of property other than the sale of property of a kind properly includable in inventory and property held primarily for sale to customers in the ordinary course of a trade or business are excluded. Thus, for example, gain on commodity futures contracts ordinarily would be excluded. Also excluded are all gains on the lapse or termination of options to buy or sell securities written by the organization in connection with its investment activities.

5. Income from various research activities also is excluded. All income from research performed for the United States, a State, or a political subdivision of a State is excluded. In the case of a college, university, or hospital and in the case of an organization operating primarily for the purpose of carrying on fundamental research that makes the results of its research freely available to the public, all income derived from research is excluded, regardless of for whom performed.

6. A "specific deduction" of $1,000 is allowed from unrelated business taxable income for all tax-exempt organizations, thus preventing the imposition of tax when the profit from an unrelated business activity is very small.

As noted earlier, the modifications for interest, royalties, annuities and rents do not apply to an 80-percent controlled subsidiary to the extent it is engaged in a trade or business unrelated to the exempt purpose of the parent organization.

Special rules apply in computing the UBTI of social clubs, voluntary employees' beneficiary associations, supplemental unemployment benefit trusts and group legal services organizations. In general, all income of these organizations other than "exempt function income" is UBTI. Exempt function income is income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members (or their dependents or guests) goods, facilities or services in furtherance of the organization's exempt purpose, and income set aside for charitable purposes or for certain defined benefits. In the case of voluntary employees' beneficiary associations, supplemental unemployment benefit trusts, and group legal services organizations, there are in addition various limits on the extent to which such set aside income is treated as exempt function income. The primary effect of these rules is to tax the investment income of the organizations subject to the rules.

The provisions pertaining to "unrelated debt-financed income" represent an exception to the general rules in that a charitable organization can have unrelated business taxable income under this section, regardless of whether it is engaged in a trade or business. The section provides that to the extent any property held for the production of income is debt-financed, the income from the property is subject to tax.

There are a number of exclusions from the definition of debt-financed property, including the following: (1) property the use of which is substantially related to the exempt purpose of the organization, (2) property used for research activities, the income from which is specifically excluded from tax under section 512, and (3) property used in certain other trades or businesses, the income from which is excluded under section 513, namely, businesses run by volunteers, businesses run for the convenience of members, students, etc., and businesses involving the sale of donated property.

A final, and very significant, exception to the debt-financed income rules is an exception, added in 1980 and subsequently amended, for the acquisition of real estate by "qualified organizations," namely, educational institutions, pension trusts, and real property title holding companies exempt under section 501(c)(25). Section 514(c)(9) provides that the term "acquisition indebtedness" does not include debt incurred by a qualified organization to purchase real property so long as certain conditions are met. These conditions include: (1) the purchase price is a fixed amount; (2) the amount of any indebtedness, and the time for payment of such indebtedness, is not contingent on revenue, income, or profits derived from the real property; (3) the real property is not leased back to the seller or a party related to the seller; (4) the real property, if purchased by a pension trust, is neither purchased from, nor leased to, certain disqualified persons; (5) neither the seller nor a related party or certain disqualified persons (in the case of a pension trust) provides financing in connection with the real property; and (6) if the real property is held by a partnership and one or more of the partners is not a qualified organization, then allocations to the partners must be qualified allocations or must not have as a principal purpose the avoidance of income tax. An allocation to a tax-exempt partner is a qualified allocation if each item of income, gain, loss, deduction, credit, and basis is allocated to the tax-exempt partner in the same percentage share during the entire period the tax-exempt organization is a partner. The elaborate requirements of section 514(c)(9) were designed, in part, to prevent charitable organizations from entering into the type of "bootstrap" acquisitions that were common prior to the Tax Reform Act of 1969.

III. Tax Policy Considerations

A. Rationale for Tax Exemption of Nonprofit Organizations

As described above, the legislative record provides little direct evidence as to the original rationale for the exemption of certain organizations from tax. Moreover, the current diversity in activities and funding of the exempt sector suggests that the scope of tax exemption under current law reflects a variety of policy considerations. For example, an organization that draws all of its revenues from donations has no taxable income in any conventional sense. Certain other organizations, such as labor unions or trade associations, are funded principally by membership dues and may appropriately be characterized as mutual benefit organizations that function, in part, as conduits for their members.

The broadest segment of the exempt sector, however, including specifically those organizations engaged in the educational, health and charitable activities identified in section 501(c)(3) (public charities), draw substantial revenues from sources that could, at least in concept, be subject to income tax. Tax exemption for these organizations may, in part, reflect historical circumstances, but is more importantly based on the same tax policy principles that support an income tax deduction for charitable contributions. Taxes are imposed to fund the activities of government, and represent a removal of resources from private hands to support the broad, public purposes served by government. Although public charities are privately operated and controlled, their exempt activities are restricted to those deemed to serve the general public interest. An organization that provides food and shelter for the poor, or that encourages education, the arts or humanities, is serving the same general purposes with which government itself is concerned. Thus, resources dedicated to the activities of such organizations may be viewed as similar to funds transferred to and used for the general purposes of government. For this reason, income transferred through a charitable contribution or earned directly by a public charity may appropriately be exempted from tax.

Although the above rationale for exempting public charities and their activities from taxation remains as strong today as when the income tax was first enacted, limits on the scope of such tax exemption are appropriate and necessary. This nation has prospered through its reliance on a private, market-based economy to supply necessary goods and services. The role of government generally has been restricted to those socially important activities not adequately supported by the private sector. The role of the quasi-governmental, not-for-profit sector should similarly be restricted to that of supplementing, and not supplanting, the activities of for-profit businesses. Thus, tax exemption for public charities should be restricted to those areas where the quality or quantity of goods and services that would be produced strictly through market forces is inadequate.

B. The Problem of Competition

As described above, Congress adopted the unrelated business income tax primarily because of its concern with "unfair" competition between tax-exempt organizations and taxable businesses. Some competition between tax-exempt and taxable activities is inevitable, however, and could not be eliminated without repealing altogether the tax exemption for nonprofit organizations. A nonprofit hospital will compete with for-profit hospitals for patients, and in providing its patients with food, drugs or medical devices will compete with taxable businesses offering the same products. Similarly, in maintaining student dormitories, an exempt university will compete with local businesses offering meals and housing. Because the hospital and university are not subject to tax, they may be able to provide goods or services at a lower cost than their taxable competitors or to expand more rapidly to attract additional students or patients.3/ Although this may leave the exempt organization with a competitive advantage over its taxable counterpart,4/ this advantage is an intended consequence of the societal decision to encourage the exempt functions performed by these organizations.

Competition between taxable and tax-exempt organizations becomes of greater concern, however, when the good or service provided by the tax-exempt organization is further removed from the organization's core purposes. We may not be concerned that a state university's tax exemption extends to sales of textbooks through the student bookstore, since the product is essential to the school's educational function and may be irregularly or incompletely supplied by private businesses. If the same student

---

3/ Although tax exemption may provide an organization with the ability to underprice taxable competitors, the actual effect of tax exemption on an organization's commercial behavior is not clear. While some exempt organizations may price their goods and services at less than what the market will bear, others may seek to maximize financial returns because of concerns such as funding or expansion.

4/ Organizations exempt from federal income tax are commonly entitled to other benefits, such as lower postal rates, exemptions from certain federal excise taxes, and exemption from state and local income, property, sales, and excise taxes. These benefits may be as important, if not more important, than the exemption from federal income tax.

bookstore, however, also sells clothes, appliances and other consumer goods, the activity moves further from the university's educational function, and involves products which in general are amply supplied by the private sector. Extending the university's tax exemption to sales of these products may only displace taxable businesses in an area where private markets are working effectively.

C. Accountability

As indicated above, the privilege of tax-exempt status affords substantial benefits and, at least with respect to public charities, may be justified because of the public, quasi-governmental purposes served by their activities. Because nonprofit organizations are privately controlled, however, their activities are not subject to the public review or scrutiny that applies to the actions of government. It is thus necessary that the tax system ensure that nonprofit organizations are operated for the purposes that support their exemption.

At present, the responsibility for ensuring that nonprofit organizations are accountable for the benefits of tax exemption in large part rests on the enforcement activities of the Internal Revenue Service. Through the return and audit process, the Internal Revenue Service is in a position to review the activities of nonprofit organizations and the purposes for which their funds are spent. In addition to focusing on an exempt organization's use of funds, however, the tax system may improve accountability by encouraging particular sources of funding. Thus, rules limiting the scope of tax exemption may appropriately encourage an exempt organization to concentrate on activities and investments that do not distract from its exempt function. This channelling function may be served by the current law rules subjecting nonprofit organizations to tax on their unrelated business activities. Although the earnings from an unrelated business activity may go equally to serve the organization's exempt purposes, the unrelated activity may divert management resources or otherwise cause the organization to lose sight of its exempt function. In the same vein, the current law rules exempting passive investment income, whether or not related to a nonprofit organization's exempt function, effectively encourage investments that will not directly engage the organization in purely commercial activity.

There are of course limits on the extent to which the tax laws can be used to ensure accountability of tax-exempt organizations. For example, determining whether contributed funds are used wisely and efficiently is not a function of the tax law. Such accountability might be aided by fuller public disclosure required by the tax rules or by state authorities.

IV. Analysis of Current Law

Our analysis of current law is divided into four parts: (1) income from business activities, a category that includes all activities that consist of charging a fee for goods or services; (2) "passive" investment income such as dividends, interest, annuities, royalties and rents; (3) research activities, a class of business activities that are specifically excluded from UBTI under certain circumstances; and (4) joint ventures with taxable entities.

A. Business Activities

1. Fee-for-Service Activities that Constitute Basis for Exempt Status

A necessary threshold question in examining the income-producing activities of exempt organizations is what basic activities merit the privilege of tax exemption. Many currently exempt organizations are principally engaged in the provision of goods or services for a fee, similar in many respects to taxable, for-profit businesses. Routine examples include hospitals, schools, and organizations for the performing arts.

As discussed above, tax exemption for the income of such organizations should reflect a societal judgment that the goods or services they provide are in the public interest and would not be adequately supplied by market forces alone. The substantial benefits of tax exemption make it important, moreover, that such judgments be reexamined in light of changes both in the exempt and for-profit sectors.5/

In the over ninety years since the basic provisions identifying exempt activities were enacted, the composition of the for-profit and exempt sectors has changed dramatically. Notwithstanding this passage of time and the significant evolution in activities of exempt and taxable organizations, a comprehensive review of the standards and the rationale for tax exemption has never been undertaken. Since we understand questions concerning basic eligibility for tax exemption to be beyond the scope of this hearing, we limit ourselves at this time to noting the importance of such issues.

2. The Unrelated Business Income Tax

As previously noted, the UBIT provisions impose a tax on a trade or business regularly carried on by an exempt organization if it is not substantially related to the organization's exempt purpose. In reviewing the UBIT provisions, I will discuss the "substantially related" test, exceptions to the definition of an unrelated trade or business, and issues relating to the computation of the UBIT, especially the allocation of expenses between exempt and unrelated activities.

a. The "substantially related" test

As described earlier, the test of present law for determining whether or not a trade or business regularly carried on is exempt from tax is whether the business is substantially related to the exempt purpose of the organization, aside from the need for funds. Treasury regulations elaborate upon the meaning of the term "substantially related" by requiring that the business

---

5/ Congress has on several occasions concluded that tax-exemption for a particular class of organizations was no longer warranted. For example, tax exemption was repealed in 1951 for mutual savings banks and savings and loan associations; in 1962 for mutual property and casualty companies; in 1984 for the Federal Home Loan Mortgage Corporation ("Freddie Mac"); and in 1986 for organizations that provide commercial-type insurance as a substantial part of their activities such as Blue Cross and Blue Shield.

activity have a substantial causal relationship to accomplishment of the organization's exempt purposes. Thus, the activity which generates income must "contribute importantly" to the accomplishment of the exempt purposes for which the organization was formed, a determination that depends in each case upon the facts and circumstances involved. Examples of activities ordinarily viewed as "substantially related" include school-sponsored athletic events and university publication of scholarly works.

The regulations further provide that the sale of products resulting from the performance of exempt functions does not constitute an unrelated trade or business if the product is sold in substantially the same state as on completion of the exempt function. Thus, the sale of milk by a scientific organization that maintains an experimental dairy herd would not constitute an unrelated trade or business, but the sale of ice cream would. Similarly, the regulations provide that to the extent a business is conducted on a larger scale than reasonably necessary to accomplish the organization's exempt purpose, income from the activity is taxable.

Although the "substantially related" test raises a number of administrative and compliance concerns, which are discussed below, we believe the standard, as interpreted by the regulations, has conceptual merit. As previously noted, tax exemption may appropriately be granted for activities that are socially important and would not be adequately supplied by market forces alone. Assuming an organization merits exemption under this standard, tax-exemption should appropriately extend to that collection of activities that are substantially or integrally related to the organization's exempt functions. Thus, for example, a university's tax exemption should extend to the provision of dormitory housing, given the university's significant interest in maintaining a campus and assuring students of standard, affordable housing with reasonable access to university facilities. On the other hand, tax exemption might appropriately be denied to a university-maintained student record store, which ordinarily would simply duplicate private sector businesses without importantly advancing the school's educational purposes.

Our primary concern with the "substantially related" test is whether in practice it has been useful in distinguishing activities entitled to exemption from those that are not. The general concepts enunciated in the regulations inherently require facts and circumstances determinations that are not likely to achieve consistency among different exempt organizations. The practical result appears to be an *ad hoc* test that, in many cases, offers inadequate guidance *to the* courts, exempt organizations, and revenue agents. Moreover, to the extent the relatedness standard has provided guidance, there are indications it has been applied in an overly generous manner. Some courts appear to have found the requirement that an activity contribute importantly to an organization's exempt purpose satisfied where the activity contributes simply in some way to that purpose.[6]

---

[6] *See, e.g., Hi-Plains Hospital v. U.S.*, 670 F.2d 528 (5th Cir. 1981) (sale of drugs by hospital to nonhospital patients of doctors on the hospital staff held related); *St. Luke's Hospital of Kansas City v. U.S.*, 80-2 USTC 9533 (W.D. Mo. 1980) (performance of routine laboratory analysis of diagnostic tests for nonhospital patients of doctors on the hospital staff held related).

Our concerns in this area are heightened by evidence, albeit inconclusive, that some exempt organizations are aggressively seeking tax-exempt income-producing opportunities. For example, an increasing number of publications and seminars are advising exempt organizations of ways to increase their revenues through the operation of related businesses. Moreover, as stated above, current data suggest that exempt organizations are relying to an increasing extent on income-producing activities as a source of revenue.

In summary, although we believe that the substantially related test has conceptual merit, we are concerned that its inherent generality is a source of administrative difficulty. Since we are not certain at this point of the direction a more administrable standard should take, we believe efforts should focus instead on obtaining more detailed information concerning the revenues of exempt organizations and the basis for treating them as tax exempt. For example, useful information might be obtained through an expanded Form 990, with appropriate penalties for failure to file or incomplete reporting. Such additional detailed reporting could provide the basis for better enforcement and compliance as well as for a more informed evaluation of the adequacy of the relatedness test.

b. Exceptions to the definition of an unrelated business

There are a number of exceptions to the definition of an unrelated business, including businesses carried on by volunteers; businesses carried on by public charities and state schools primarily for the convenience of members, students, patients, officers or employees; and businesses involving the sale of donated property.

(1) Businesses operated by volunteers

The exception for businesses operated by volunteers was part of the original unrelated business income tax enacted in 1950. Although the Committee Reports do not state the reason for the exception, there are a number of considerations that, while not entirely satisfactory, provide some justification for the exception. First, Congress was concerned with unfair competition. It may have viewed the requirement that substantially all the work be performed by volunteers as an inherent limitation on the growth and competitive strength of such organizations. On the other hand, one could argue that the use of volunteer labor would itself constitute unfair competition because it would lower the costs of the business. Second, Congress may have been concerned that general rules for computing taxable income were not appropriate for businesses conducted by volunteers. In concept, a salary payment and offsetting charitable contribution could be imputed between the organization and the volunteer. Failure to reduce the organization's taxable income for the imputed cost of its labor arguably overtaxes the organization's income. Although an overly broad response, tax exemption for volunteer activities prevents such possible overtaxation. Finally, Congress may have viewed the provision simply as a means of exempting small fundraising activities, such as a weekly fish fry sponsored by a veteran's organization or a craft shop operated by a church.

We believe the above considerations justify an exception for small volunteer businesses conducted by charities for fundraising purposes. At the same time, we question whether an unlimited exception for volunteer businesses is appropriate. Prior to putting forward any specific proposal, however, we would need to develop additional information as to the character and size of businesses currently relying on the volunteer exception.

(2) Convenience of members, etc.

The legislative history of the Revenue Act of 1950 indicates that the exception for businesses carried on primarily for the convenience of members, students, patients, officers or employees prevented the taxation of dining halls and dormitories operated by educational institutions. A hospital cafeteria serving primarily patients and employees also would fall under this exception. Although we agree that dining halls, dormitories and hospital cafeterias should generally be exempt from tax, such businesses would in most instances be treated as substantially related to the exempt purpose of the organization and hence not require a special exception. The convenience exception might be asserted to protect other cases, however, such as university-sponsored travel services or student stores offering clothing and records, that probably would not merit tax exemption under the substantially related standard.

We question the tax policy justification for an exception from the UBIT for a business activity solely on the grounds of "convenience" for members, students, patients, etc. Since activities important to an organization's exempt function are protected under the substantially related standard, a "convenience" exception would appear defensible only if it provided significant administrative benefits. Since this also is an area in which we lack data as to the character and size of the businesses relying on the exception, we again would require additional information before offering a specific proposal.

(3) Donated property

The exception for businesses selling donated property was designed to prevent thrift shops operated by exempt organizations from paying income tax on the sale of donated property. Although there exists competition between taxable and tax-exempt thrift shops, we believe most exempt thrift shops would generate little, if any, taxable income, and that the exception is justified on grounds of administrative convenience. The recipient of donated property generally takes a basis in the property equal to the lesser of the donor's basis or fair market value. Since most donated property of the type sold in thrift shops has depreciated in value, basis would usually equal fair market value, which ordinarily would also be the price at which the property was sold.

c. Computation of UBIT

To the extent an exempt organization is taxable on an unrelated business, present law generally taxes the unrelated business in the same manner as if the business were carried on by a taxable entity. I would like to discuss three issues concerning the computation of UBIT -- the allocation of expenses, the specific deduction, and the fragmentation rule.

(1) Allocation of expenses

The proper allocation of expenses between related and unrelated businesses is one of the most difficult issues that arises in determining an exempt organization's unrelated business taxable income. Unrelated business taxable income is defined as gross income derived from an unrelated business less allowable deductions "directly connected" with the carrying on of such business. In interpreting this language, the regulations provide that an item of deduction not only must satisfy the general requirements of deductibility for a trade or business, but must also have a "proximate and primary relationship" to the carrying on of a business. Where facilities and personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, the regulations provide that expenses, depreciation and similar items (as, for example, items of overhead) shall be allocated between the two uses on a reasonable basis.

In a recent case of first impression, Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d. 1058 (2d Cir. 1984), the Second Circuit Court of Appeals held that substantial fixed costs associated with a field house owned by an educational institution were properly allocated between related and unrelated uses when allocated on the basis of the total time the field house was used. In Rensselaer, the field house was operated for two broad categories of use: student uses related to the exempt purposes of the institution, and commercial uses such as ice shows and public ice skating. Substantial fixed costs associated with the field house, such as depreciation, salaries and maintenance, were incurred regardless of whether the field house was used on a commercial basis. The institution took the position that these expenses should be allocated based on a comparison of hours used for exempt activities and hours used for commercial activities. Thus, if the field house was used on average 15 hours per week for exempt functions and 15 hours per week for unrelated business activities, the institution would allocate fixed costs evenly between the two uses. The Internal Revenue Service argued that the fixed costs should be allocated based on hours of use in the unrelated business compared to the total time available for use, thus allowing a smaller deduction against the unrelated business income.

The court in Rensselaer held that the institution properly allocated costs between the exempt and the taxable uses of the field house in the same manner as expenses would normally be allocated between two taxable businesses. That is, costs could be allocated ratably between the exempt and non-exempt uses in accordance with respective hours of use for the two purposes. Thus, the taxable income of the institution was substantially reduced because the unrelated business was allowed to deduct expenses that would have been incurred in any event.

We believe that the allocation method endorsed in Rensselaer fails to properly distinguish between an organization's exempt and unrelated activities. In the context of a purely commercial entity, it may be appropriate to regard all income-producing activities as of equal significance, and thus as equally supporting an allocation of fixed costs. Given the benefits of tax exemption, however, and the terms under which it is granted, it is appropriate to restrict allocations to unrelated activities of costs necessary to the conduct of an organization's exempt function.

Issues analogous to those faced in Rensselaer have previously been faced with respect to commercial uses of a taxpayer's principal residence, such as a home office. Similar to an exempt organization's use of its facilities in an unrelated business, an individual's use of his home to provide a business office may appropriately be regarded as a marginal or incremental activity in relation to the home's primary residential function. Under current law, section 280A reflects this approach by generally denying deductions for a home office to the extent the office space is also used for residential purposes. Moreover, prior to the very strict limitations adopted in section 280A, the same allocation method approved by the Second Circuit in Rensselaer had not gained general acceptance with respect to the home office deduction. Thus, although there is also authority to the contrary, the Ninth Circuit, in Gino v. Commissioner, 538 F.2d 833 (9th Cir.), cert. denied, 429 U.S. 979 (1976), held that expenses must be allocated on the basis of available time for use rather than actual use. Finally, it is noteworthy that, when Congress enacted an exception to the strict limitations of section 280A for personal residences used for providing day care services, it expressly provided that the total number of hours that the area is available for use is to be used in allocating expenses.

We believe an allocation method based on total available time is appropriate for exempt organizations as well. Indeed, it can be argued that no deduction at all should be allowed for fixed costs which would be incurred by the exempt organization regardless of whether it engaged in an unrelated business. Although such an approach may have theoretical merit, we are concerned that it might unduly hinder the ability of exempt organizations to acquire new facilities that would only prove economical if some portion of the facility were put to commercial use. Thus, a university seeking to build a new field house or to purchase a powerful computer might be unwilling to proceed unless commercial use could absorb some of the fixed costs. On the other hand, the method upheld in Rensselaer inappropriately encourages the conduct of unrelated businesses. We believe that the purpose of the UBIT -- to measure the income attributable to an unrelated business and to tax it on essentially the same terms as other commercial activities -- requires an allocation method based on total available time.

Although the Service may ultimately prevail in litigation on the allocation issue, clarification by Congress would be desirable. We also recommend that the allocation of expenses should in no event be permitted to exceed the fair market value of the facility used or the goods or services received. That is, if the same facility could be acquired or rented on the commercial market for $1,000, allocable expenses related to the use of such facility could not exceed $1,000.

(2) The specific deduction

Under current law, a "specific deduction" of $1,000 is allowed against unrelated business taxable income. This deduction allows exempt organizations that carry on an unrelated business with only a small amount of profit to be free of the obligation to file a tax return and pay tax. We believe that such an exception to the general rule of taxing unrelated business income is desirable. In light of the fact that the $1,000 amount has not been increased since its enactment in 1950, we suggest increasing the amount to $5,000 in order to compensate for the effects of inflation.7/ Because the specific deduction is not intended to subsidize large unrelated businesses, however, we suggest the benefit of the $5,000 deduction be phased out for organizations with a substantial amount of unrelated business taxable income, perhaps in excess of $50,000.

7/ The $1,000 deduction in 1950 dollars is equivalent to $4,800 in 1986 dollars.

(3) The fragmentation rule

Another problem area with unrelated businesses carried on directly by exempt organizations is the application of what is sometimes referred to as the "fragmentation" rule -- the rule that any activity carried on for the production of income can constitute an unrelated business even if it is part of a larger aggregate of activities, some of which are related to the exempt purposes of the organization.

The difficulties with the fragmentation rule are most evident in the tax treatment of retail businesses such as museum gift shops. Under present law, for example, a museum is required to make an item-by-item determination of which sales by its gift shop constitute a related business (for example, sales of reproductions) and which constitute an unrelated business (sales of souvenirs). This requirement imposes a significant administrative burden on both exempt organizations and the Internal Revenue Service. Nevertheless, we believe the rule is necessary to enforce the appropriate and intended limits on the scope of tax exemption.

3. Unrelated businesses carried on by subsidiaries

It is not uncommon for an exempt organization desiring to engage in an unrelated business to operate the business through a taxable subsidiary. The subsidiary is an independent taxpaying entity that is subject to the same tax rules as if it were owned by a taxable entity or by individual shareholders. Dividends paid by the subsidiary to the tax-exempt parent are treated in the same manner as any dividend received by the parent -- they are specifically excluded from tax on unrelated business income.

Two important issues regarding the use of taxable subsidiaries include first, the treatment of rents, royalties, interest and annuities received from a "controlled" subsidiary and, second, the effect of subsidiaries on the determination of whether a charitable organization is operated for the primary purpose of carrying on an unrelated trade or business.

a. Controlled subsidiaries

There are a variety of non-tax reasons for an exempt organization to make use of taxable subsidiaries, including concerns about commercial liability and the desire to have the taxable business operated and accounted for separately from the primary exempt activity. There are also tax reasons for utilizing a taxable subsidiary. Chief among these is the ability to make tax deductible payments to the parent that reduce the subsidiary's taxable income but are not taxed to the parent because of the specific exclusions for interest, rent, annuities or royalties. If an exempt organization directly carries on the unrelated business of manufacturing sweatshirts embossed with the organization's logo, for example, the organization is taxed on its gross income less deductions "directly connected" with the business. But if the organization were to drop the sweatshirt business into a taxable subsidiary, with a minor interest held by another taxpayer, the subsidiary would be free to pay to the parent organization rent for the use of its building, a royalty for the use of the logo, and interest on money loaned to the subsidiary by the parent. These payments, which could not be used to reduce taxable income if the business were carried on directly by the exempt organization, are deductible by the subsidiary and excluded from the taxable income of the exempt organization.

Although present law attempts to deal with this problem by means of a special rule for controlled subsidiaries, the statutory language is inadequate. As described earlier, if a subsidiary of a tax-exempt organization is "controlled" by the parent, interest, annuities, royalties and rents received by the parent constitute unrelated taxable income to the extent the activities of the subsidiary are unrelated to the exempt purpose of the parent. A subsidiary is a "controlled organization" if the exempt organization owns at least 80 percent of the total combined voting power of all classes of stock entitled to vote and 80 percent of the total number of shares of all other classes of stock.

The problem with the current definition of a controlled organization is that it is relatively easy to have a subsidiary fail the "controlled organization" test. For example, an exempt organization could own 100 percent of the voting stock of a subsidiary, 99 percent of the total value of a subsidiary, but only 79 percent of a single class of nonvoting stock, and the subsidiary would not technically fall within the definition of a controlled organization. In the alternative, an exempt organization could have a directly controlled affiliated organization hold 100 percent of the stock of the subsidiary. Because the controlled organization test of present law does not include ownership attribution rules, the exempt organization could argue that it is free to receive the rent, interest and royalties tax free even though it has complete control, albeit indirectly, over the subsidiary.

Present law would be significantly improved by making two changes to the controlled organization provision. First, the definition of a controlled organization should be changed to include an organization in which the parent exempt organization has more than a 50 percent interest, measured either by voting power or value. In such cases, it is reasonable to assume that the exempt organization exercises sufficient control over the subsidiary to direct its everyday activities, including amounts paid for rent, royalties and interest. Because of this close association, it is inappropriate to view the income from such payments as passive income to the exempt parent. Second, appropriate ownership attribution rules should be enacted.8/

8/ The 1986 Tax Reform Act dealt with an analogous problem -- payments to a foreign government by a corporation controlled by it -- in a similar fashion. The income of foreign governments received from certain investments in the United States is exempt from tax but other income may be taxable. Under prior law a foreign government could establish a U.S. subsidiary which engaged in commercial business activities. The subsidiary could pay interest or royalties to the foreign government which would reduce the taxable income of the subsidiary and would not be taxed to the government because of the tax exemption for certain investment income. To eliminate this problem, section 892 of the Code was amended to provide that payments by a "controlled commercial entity" to a foreign government would not enjoy the tax exemption. For this purpose, a controlled commercial entity is any entity engaged in commercial activities that is directly or indirectly owned at least 50 percent by the foreign government.

b. "Primary purpose" test

As described earlier, regulations under section 501(c)(3) of the Code provide that a section 501(c)(3) organization can engage in a business as a substantial part of its activities so long as the operation of the business is in furtherance of the organization's exempt purpose and the organization is not organized or operated for the primary purpose of carrying on an unrelated business. Thus, if a charitable organization carried on an unrelated business with a million dollars of net revenue each year, but made comparatively small expenditures for carrying on the purpose for which it was granted tax exemption, it would cease to qualify as a section 501(c)(3) organization.

The question arises whether the above result should be any different if the organization instead puts the unrelated business into a subsidiary. Although operation of an unrelated business in a subsidiary may protect the exempt organization from liabilities of the business and otherwise require less direct and active involvement, we do not believe it eliminates concern that the unrelated business could supplant the organization's exempt function as its primary purpose. As is common in the taxable sector, management of a subsidiary may be fully integrated with that of its parent. Although we are not aware of cases in which an unrelated business has been transferred to or formed in a subsidiary in order to avoid the primary purpose test, we believe consideration should be given to a rule that in appropriate cases aggregates the activities of an exempt organization and its subsidiaries for this purpose.

B. "Passive" Income

1. In General

The definition of unrelated business income excludes dividends, interest, annuities, royalties and rents (collectively referred to as "passive" investment income).9/ In explaining the continued exemption for passive investment income at the time the UBIT was enacted in 1950, Congress stated that such income had long been recognized as proper for charitable and educational organizations and was not likely to generate competitive problems for taxable businesses.

The importance of passive income to the exempt sector makes it appropriate that the grounds for its exemption again be examined. My testimony will, thus, discuss the policy considerations concerning the passive income exception for the broadest segment of the exempt sector. These are public charities exempt under section 501(c)(3), social welfare organizations exempt under section 501(c)(4), labor unions exempt under section 501(c)(5), and trade associations exempt under section 501(c)(6).

9/ Although such income is referred to as "passive" for purposes of this testimony, current law has not been interpreted as requiring that the exempt organization's activity be passive.

a. Public charities

As discussed above, tax exemption for income earned by public charities can be justified on the grounds that the income will be used to support organizations, as identified in section 501(c)(3), deemed to act for the general public good. We believe this rationale appropriately extends to passive investment income of public charities. Moreover, we do not believe the concerns justifying a tax on an exempt organization's unrelated business activities apply with respect to passive investments. Although we recognize that the line between a passive investment and an active business is at times very thin, an exempt organization's investment of capital in a taxable business should not generally raise concerns over unfair competition. Moreover, we believe the exemption for passive investment income may appropriately encourage exempt organizations to avoid deeper commercial involvements and the potential distractions and conflicts they present. Thus, although we have some concerns, as discussed below, about the current law rules defining passive investment income, we think tax exemption for such income earned by public charities is appropriate.

b. Social welfare organizations

An organization is exempt under section 501(c)(4) as a social welfare organization if it is primarily engaged in promoting the common good and general welfare of the community. The term "social welfare" as used in section 501(c)(4) is similar to "charitable purposes" as used in section 501(c)(3) and there is a substantial degree of overlap between the two provisions. Social welfare organizations, however, are allowed to engage in political activities or lobbying on a scale that is not permitted by section 501(c)(3). On the other hand, consistent with the nondeductibility of most lobbying and political expenses, contributions to social welfare organizations are not deductible. Although passive investment income of a social welfare organization is excluded from UBTI, this exception is partially overridden by section 527 (relating to political organizations) which imposes a tax on investment income of all organizations exempt under section 501(a), to the extent that such income is expended on political activities.

Since social welfare organizations are not limited to the purposes served by public charities and, in particular, may expend significant amounts on lobbying and political activities, an unlimited exemption for their passive income is not appropriate. As previously noted, under current law, social welfare organizations are taxed on investment income only to the extent that it is expended on political activities. We believe there is no justification, however, for exempting passive income that is expended for lobbying or other purposes not identified in section 501(c)(3). Thus, we suggest that passive income of social welfare organizations be taxed, except to the extent that it is expended or permanently set aside for the purposes identified in section 501(c)(3) (i.e., religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals).

c. Labor unions and trade associations

Mutual benefit organizations, such as labor unions and trade associations, enable their members to pool their funds in order to accomplish more efficiently activities that might be undertaken separately by the members. Labor unions thus engage in collective bargaining and may pay certain benefits to their members. Similarly, trade association activities are directed toward the improvement of business conditions. Tax-exempt status for such organizations is generally justified on the grounds that the organization acts as a conduit for its members. In line with this rationale, investment income of such organizations should, in concept, be treated in a manner that is neither more nor less beneficial than the treatment such income would receive if earned separately by the organization's members.

The appropriate tax treatment for investment income of labor unions and trade associations is best understood in the context of the tax treatment accorded to their members upon the payment of membership dues. To the extent the expenditures of a union or trade association would be deductible if incurred directly by its members, exemption of investment income may produce the same practical result as if the income was earned and expenditures incurred directly by the members. In fact, however, while trade association dues are generally deductible by members as business expenses, most employee business expenses, including labor union dues, are deductible only by members that itemize their deductions, and only to the extent that the taxpayer's miscellaneous itemized deductions exceed two percent of the taxpayer's adjusted gross income. In some cases, exemption of investment income may thus effectively provide a deduction for expenses that would not be deductible if incurred by members directly. Moreover, even if dues are deductible by the members, to the extent investment income is earned in one year and spent in a later year, exemption effectively provides the benefit of a deduction before the expenditure is actually made.10/

In sum, the deficiency in the current treatment of labor union and trade association investment income is that it grants a current deduction for a future expense and assumes, incorrectly in many cases, that the organization's expenditures would be deductible if incurred by the members. The obvious virtue of current law is its simplicity, which should be abandoned only if the revenue loss associated with current law is significant enough to justify the increased complexity that would result if investment income of these organizations were taxed. Although increased complexity might be avoided if gross investment income was simply taxed to the organization, a deduction for amounts expended for the organization's exempt purposes would, at least in concept, be appropriate to the extent membership dues are deductible by the members.

10/ For a more detailed discussion of these points, see Bittker and Rahdert, The Exemption of Nonprofit Organizations from Federal Taxation, 85 Yale L.J. 229, 353-357 (1976).

2. Royalties

The exclusion of royalties from UBTI raises issues in addition to those discussed above with respect to passive income generally. The statute excludes "all royalties... whether measured by production or by gross or taxable income from the property." Although neither the statute nor the regulations define the term "royalties" for purposes of the passive income exception, there is legal authority for treating essentially any payment for the right to use intangible property as a royalty for tax purposes.

Because of the exceedingly broad definition of a royalty and because the statute allows payments to be measured by taxable income, the exception for royalty income permits exempt organizations to use licensing agreements to obtain a portion of the profits of an unrelated business without incurring tax liability. For example, if an organization sold tote bags bearing its logo, the sales would be taxed as an unrelated trade or business. If, however, the organization licensed the right to use its logo to a third party in exchange for a share of taxable income, the organization's income would be treated as tax-free royalty income, notwithstanding the fact that the organization in essence would be sharing in the net profits of the business. This would be the result even if the organization retained the right to approve the quality or style of the products. It is difficult to justify these results from a tax policy perspective. In cases where the organization shares in the net profits of a business, as opposed to the gross income or receipts, it is more akin to a partner in an active business than to a passive investor.

Another concern with the exclusion for royalties is that in many cases, such as where the organization licenses the right to use its name or trademark, the licensing agreement is in essence an endorsement of a commercial product. The regulations provide that where goodwill or other intangibles generated by the performance of an organization's exempt functions are exploited for a commercial purpose, the resulting income is unrelated business income, unless the commercial activities themselves contribute importantly to accomplishment of the organization's exempt purpose. The regulations provide as an example of such unrelated business income an exempt scientific organization which enjoys an excellent reputation in the field of biological research, and exploits its reputation by selling endorsements of various items of laboratory equipment to manufacturers. The organization, however, could effectively endorse the same products and avoid tax liability by licensing the right to use its name or trademark instead of actively endorsing the equipment.

We are concerned that the current broad scope of the passive income royalty exception may permit organizations to avoid tax liability on activities that the UBIT is intended to reach. Although we believe additional information is necessary concerning the extent of such activities, consideration should be given to narrowing the definition of a royalty. For example, royalties might be defined to exclude amounts measured by net profits.11/ Such a restriction on the definition of royalties for purposes of the passive income exception would be consistent with restrictions imposed on the definition of rents. In addition, consideration should be given to excluding from the definition of a royalty situations where an exempt organization is exploiting goodwill and other intangibles generated by its exempt purposes.

C. Research Activities

Current tax law provides broad exemptions for research activities conducted by exempt organizations. If research activities are substantially related to an organization's exempt purpose they are not taxable. In addition, the law contains three specific exclusions from UBTI for research activities, which are applicable without regard to whether the research is related to the organization's exempt purpose. First, section 512(b)(7) excludes all income derived from research for the United States or any State or political subdivision. Second, in the case of a college, university, or hospital, section 512(b)(8) excludes all income derived from research performed for any person. Third, section 512(b)(9) excludes all income derived from research performed for any person in the case of an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the public.

The term research is not precisely defined in the statute, the regulations or the case law. The regulations provide that research includes both basic and applied research, but does not include "activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products, the designing or construction of equipment, buildings, etc." In a recent Claims Court case involving a scientific organization exempt under section 501(c)(3), scientific research was broadly defined to include any activity that: "1) involve[s] the use of observations or experimentation to formulate or verify facts or natural laws; 2) can only be performed by an individual with advanced scientific or technical expertise; 3) adds to knowledge within a particular scientific field; 4) involves the application of mathematical reasoning; and/or, 5) is an attempt to systematize or classify a body of scientific knowledge by collecting information and presenting it in a useful form." IIT Research Institute v. United States, 9 Cl. Ct. 13 (1985).

In determining whether a research activity that does not qualify for one of the specific exclusions is exempt as a related trade or business, the substantially related test is the applicable standard. Thus, for example, testing by a university that does not meet the definition of research may be considered related to the university's teaching function. The regulations concerning what constitutes a scientific organization for purposes of the basic tax exemption under section 501(c)(3) also are pertinent. While the definition of a related trade or business is broader than the definition of an exempt scientific organization, any activity that would qualify an organization for the exemption under section 501(c)(3) clearly would be a related activity for purposes of the UBIT. Thus, the definition of a scientific organization for purposes of the basic tax exemption functions as a safe harbor. A scientific organization is exempt if it carries on "scientific research in the public interest".

11/ In light of the long-established practice of treating an interest in mineral property calculated as a net profits interest as an interest in gross production, an exception for such mineral royalties would be appropriate.

Scientific research is regarded as carried on in the public interest if one of three tests is met: (1) any patents, copyrights or processes are made available to the public on a nondiscriminatory basis; (2) the research is performed for the United States or a State or political subdivision; or (3) the research is directed toward benefiting the public.

The regulations provide the following examples of research which benefits the public: 1) scientific research carried on for the purpose of aiding in the scientific education of college or university students; (2) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; (3) scientific research carried on for the purpose of discovering a cure for a disease; or (4) scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area. Scientific research that meets one of the standards in the regulations for benefiting the public will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes or formulae resulting from such research.

In addition to the provisions exempting various research activities from tax, the Federal government provides other incentives for research in the exempt sector. First, the government encourages research through grants to universities and other exempt organizations. Second, the Uniform Federal Patent Policy Act gives universities ownership rights to patents developed as a result of federal funding of research. The stated purpose of this act is to encourage the transfer of university research discoveries to the for-profit sector for product development. Third, the tax law provides a credit to corporations that make cash payments to certain exempt educational institutions and scientific research organizations. Fourth, the tax law provides generous tax deductions for certain contributions of scientific equipment to such organizations.

As we have previously stated in testimony concerning the tax credit for research expenses, we believe it is appropriate for the Federal government to provide incentives for certain research activities. This policy reflects the critical importance of research to our national economy and the belief that some research activities would not be adequately supported by the private sector in the absence of governmental incentives. Consideration of tax exemptions for research activities should be viewed as a part of this larger national debate concerning appropriate incentives for research and should be consistent with and complementary to our broad national goals. Thus, for example, the needs of industry for highly trained and talented scientists and the fact that universities and other exempt organizations are a source of such scientists should be taken into consideration. At the same time, however, tax exemptions for research activities must reflect the values that are unique to the exempt sector and are intended to be fostered through tax exemption. In the case of exempt scientific research organizations, universities, and teaching hospitals, a commitment to the advancement of knowledge without regard to commercial profits is of primary importance.

Consistent with the objective of providing incentives for research activities that are not adequately supported by the private sector and fostering the advancement of knowledge, the tax exemption provisions for research activities should identify the type of research activity that we wish to encourage and should provide requirements to ensure that the public benefits from tax-exempt research. Although we recognize the difficulty in bringing precision to a concept as broad as research, we believe it important that additional guidance be provided as to the types of applied, purely commercial activities that do not merit tax exemption. In addition, we believe that specific requirements concerning public dissemination of research results are required to ensure that the public benefits from the tax exemption provided for certain commercial research. In raising the above issues, we recognize that the exempt sector is itself concerned that the scientific and educational purposes of exempt organizations may be undercut by the commercial potential of research activities. We thus encourage the participation of the scientific and academic communities in the development of appropriate standards for the conduct of tax-exempt research activities.

D. Joint Ventures

An area that has generated considerable controversy and uncertainty in recent years is the use of partnerships by exempt organizations as a means of accomplishing their exempt purposes and as investment vehicles. Where partnerships are used to further an organization's exempt purpose, the exempt organization typically participates as a general partner. Such arrangements have been used, for example, by exempt housing organizations to own and operate housing for low- and moderate-income persons, and by hospitals to construct and operate medical office buildings and to acquire and operate C.T. Scanners. Where partnerships are used for investment purposes, the exempt organization is typically a limited partner.

In some cases, joint ventures may provide a creative means of accomplishing socially desirable objectives. Nevertheless, such arrangements raise significant tax policy issues. I would like first to discuss certain allocation issues that arise when an exempt organization participates in a partnership with taxable partners. Thereafter, I will consider certain issues that arise when an exempt organization serves as a general partner in a partnership formed to accomplish its exempt purposes.

1. Allocation Problems

Activities conducted in partnerships between taxable and tax-exempt organizations inevitably create opportunities for the tax benefits of the activity to be shifted to the taxable partner. In response to concerns that partnership allocations may permit an exempt organization to transfer the benefit of its tax exemption, Congress has adopted restrictions on the ordinary partnership allocation rules where a tax exempt organization has taxable partners. Thus, as discussed above, Congress enacted rules in 1984 that deny the investment tax credit and accelerated depreciation to partnerships between taxable and tax-exempt entities that do not have qualified allocations. Further, the exception to the debt-financed property rules is denied to otherwise qualifying exempt organizations that are partners in real estate partnerships if the principal purpose of any allocation is the avoidance of income tax. These rules have significantly reduced the opportunities to shift tax deductions from tax-exempt to taxable partners. Moreover, the enactment of longer depreciation periods and the passive loss rules, and the repeal of the investment tax credit in 1986, reduce the available tax benefits. Nevertheless, some opportunities still exist for shifting deductions from tax-exempt to taxable partners.

As an example, assume that a taxable entity and tax-exempt organization form a partnership to acquire property for $1 million, that all depreciation deductions are allocated to the taxable partner, and that any gain on the sale of the property is allocated to the taxable partner to the extent of his depreciation deductions and then divided equally between the partners. Assume that the property is sold after 20 years. Under current law, the partnership would be required to use 40-year straight line depreciation and thus the taxable partner would have taken depreciation deductions of $500,000 by the time of the sale. If 40-year straight line depreciation is an accurate measure of true economic depreciation, then in theory the building would be sold for $500,000 ($1 million less $500,000 depreciation) and no gain would be realized. In that case, the entire sales proceeds would be allocated to the tax-exempt partner and the taxable partner would have suffered a true economic loss of $500,000. In practice, however, because of inflation and because 40 years may not represent true economic depreciation for some buildings, the building could be expected to be sold for more than its basis. Thus, for example, if the building was sold for $1 million, the gain of $500,000 would be allocated to the taxable partner. In this case, the taxable partner would have received the benefit of deducting depreciation allowances in the early years which would be offset by gain deferred until the later years. Because there is a common expectation that real estate will not decline, in nominal value, taxable partners in many instances will be willing to bet that the gain on the property will equal or exceed depreciation deductions.

To prevent the shifting of deductions from exempt to taxable partners, consideration should be given to imposing additional restrictions on allocations between taxable and tax-exempt partners. The difficulty of structuring such restrictions, however, is illustrated by the debt-financed property rules. In 1984, Congress provided that the exception to the debt-financed property rules would be available to exempt organizations holding partnership interests in real property only if the partnership had a qualified allocation. In response to complaints that this rule was overly strict, the law was amended in 1986 to require only that the principal purpose of an allocation not be tax avoidance. Adoption of this general standard, which may prove difficult to enforce, reflected the difficulty in drafting a mechanical, yet generic description of permissible allocations.

In summary, there is an inevitable incentive for tax-exempt partners to trade tax deductions for other benefits. Because of the potential for abuse in this area we believe continued attention should be given to the scope and character of the rules restricting partnership allocations between tax-exempt and taxable partners.

2. Partnerships to Perform an Exempt Function

Participation by exempt organizations as general partners in partnerships formed to conduct an exempt activity is a recent phenomenon which raises additional concerns. These concerns include whether such partnerships are incompatible with the prohibition against distribution of earnings to private interests and whether they create a conflict of interest for the exempt organization.

Current tax law with respect to participation of exempt organizations as general partners in partnerships is unclear. In order to be exempt under section 501(c)(3) an organization must be both organized and operated exclusively for an exempt purpose.

To meet the organizational test, an organization's assets must be dedicated to an exempt purpose and cannot be distributed to its members or shareholders. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Further, to be exempt under section 501(c)(3) an organization must serve a public rather than a private interest. To meet this standard, it must establish that it is not organized or operated for the benefit of private interests such as designated individuals or shareholders. Consistent with the prohibition against private benefit, an organization will not qualify for tax-exempt status if it is organized as a partnership or a for-profit corporation (i.e., a corporation that pays dividends).

The Code addresses the question of participation in partnerships only indirectly, in that it contains provisions premised on the assumption that exempt organizations may participate in partnerships. When the UBIT was enacted in 1950, for example, Congress provided that if an exempt organization is a partner in a partnership that is an unrelated trade or business with respect to the organization, the organization would be subject to the UBIT on its share of the partnership's income. Similarly, when Congress enacted rules in 1969 prohibiting private foundations from controlling active businesses, it defined permitted holdings in terms of stock ownership but directed the Treasury to prescribe regulations for partnerships consistent with the principles applicable to corporations. Further, in 1984, Congress enacted rules to deal with allocations of income and deductions between taxable and tax-exempt partners.

As stated above, organizations exempt under section 501(c)(3) are prohibited from distributing earnings to private investors. The participation by such an organization as a general partner in a partnership to conduct its exempt functions is arguably inconsistent with this rule, since the arrangement requires the exempt organization to distribute earnings from its exempt activities to private investors. Moreover, such an arrangement may place the organization in a position where it must serve two masters with conflicting purposes -- the exempt organization which has a purpose to benefit the public and the private investor which has a purpose to maximize profits.

To date, only one case, *Plumstead Theatre Society v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982), has addressed the question of whether the participation of a section 501(c)(3) organization as a general partner in a limited partnership is incompatible with its status as a charity. In *Plumstead*, a nonprofit theater organization in need of additional capital to co-produce a play entered into a limited partnership with profit-motivated individuals. In exchange for contributing $100,000 to the partnership, the two limited partners received a 63 1/2 percent share in any profits or losses resulting from the venture. The Internal Revenue Service argued before the Tax Court that the charity's activities evidenced a substantial commercial purpose and served private interests -- both violations of the operational test. In rejecting these contentions, the court found that the activities of the Plumstead Theatre Society were clearly distinguishable from those of commercial theater companies and hence did not evidence a substantial commercial purpose. In addition, the court ruled that the charity did not serve private interests in violation of the operational test. Among the factors which weighed in the Theatre Society's favor were the arm's length nature of the transaction, the lack of any obligation to return the limited partners' capital from the organization's own funds, and the lack of any control by the limited partners. The *Plumstead* decision stopped short of conferring a broad stamp of approval on the use of limited partnerships by charities, since the court rested its decision heavily on the particular facts.

Currently, the Internal Revenue Service administrative practice is to closely scrutinize such partnership arrangements to assure that the statutorily-imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable purposes. Thus, the Internal Revenue Service first determines whether the partnership is serving a charitable purpose and then examines the partnership arrangement to determine whether it permits the exempt organization to act exclusively in furtherance of its exempt purpose and not for the benefit of the limited partners.

As described above, we are concerned that an exempt organization conducting an exempt activity in a partnership with a taxable organization may violate the basic requirement that none of its earnings inure to the benefit of any private party. Whatever the advantages of such arrangements as a source of funding for an exempt organization, they may subject the organization to pressures and obligations that are inconsistent with its exempt status. For this reason, we view partnerships with taxable partners to perform an exempt activity as a matter of concern, and intend to monitor the extent of their use. We are also concerned that the only response to such arrangements under current law is loss of the organization's exempt status. This sanction is unduly severe, at least where the partnership activity relates to a limited and discrete aspect of the exempt organization's overall activities. A more appropriate result may be to make an exempt organization's income from a partnership with a taxable partner subject to UBIT.

V. Conclusion

In conclusion, we believe these hearings provide an important opportunity to reexamine, in a deliberate manner, the consequences of the tax exemption provided for various organizations and activities under current law. As I stated at the outset, our goal today has been less to set forth specific recommendations than to identify areas of policy concern, with a view to stimulating further public debate.

Although our review of this area has led us to a number of initial recommendations, we recognize the need for additional information about the current activities of exempt organizations before specific proposals can be put forth. One means to develop such information would be expanded reporting requirements, as we have recommended. In addition, these hearings will themselves generate substantial and important information about the activities of exempt organizations.

We look forward to working with this Subcommittee and other interested parties in developing such specific proposals as may prove appropriate.

This concludes my prepared remarks. I would be pleased to respond to your questions.

Figure 1. Description, General Nature of Activities, Example, and Number of Tax-Exempt Organizations, By Internal Revenue Code Section

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(1)*	Corporations organized under Act of Congress (including Federal Credit Unions)	Instrumentalities of the United States.	Federal Deposit Insurance Corp.	24
501(c)(2)	Title holding corporation for exempt organization	Holding title to property of an exempt organization.	Naugatuck Masonic Building Corp.	5,712
501(c)(3)*	Religious, educational, charitable, scientific, literary. Testing for public safety, fostering certain national or international amateur sports competitions, or prevention of cruelty to children or animals organizations. Includes private foundations and nonexempt charitable trusts.	Activities of nature implied by description of class or organization.	American Heart Association, Inc., Ford Foundation	386,987
501(c)(4)	Civil leagues, social welfare organizations, and local associations of employees	Promotion of community welfare, charitable, educational, or recreational.	Lions Clubs	129,423
501(c)(5)	Labor, agricultural, and horticultural organizations	To improve conditions of work and to improve products and efficiency.	AFL-CIO	71,182
501(c)(6)	Business leagues, chambers of commerce, real estate boards, etc.	Improvement of business conditions of one or more lines of business.	Chamber of Commerce National Football League	56,336
501(c)(7)	Social and recreational clubs	Pleasure, recreation, social activities.	Ocean Ski Club, Inc.	56,216
501(c)(8)	Fraternal beneficiary societies and associations	Lodge providing for payment of life, sickness, accident, or other benefits to members.	Knights of Columbus	86,255

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(9)	Voluntary employees' beneficiary associations (including federal employees' voluntary beneficiary associations formerly covered by section 501(c)(10))	Providing for payment of life, sickness, accident, or other benefits to members.	Warren Fire-fighers Fund Assoc.	10,481
501(c)(10)	Domestic fraternal societies and associations	Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members.	Knights Templar of the US 33 Natick Commandery	16,953
501(c)(11)	Teachers' retirement fund associations	Teachers' association for payment of retirement benefits.		9
501(c)(12)	Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, etc.	Activities of a nature similar to those implied by the descriptions of class of organization beneficial to members.	Salem Rural Water Corp.	5,345
501(c)(13)*	Cemetery companies	Burials and incidential activities for members.	Williamson Cemetery Assoc.	7,704
501(c)(14)	State chartered credit unions, mutual reserve funds	Loans to members. (Exemption for building and loan associations and cooperative banks repealed by Revenue Act of 1951, affecting all years after 1951).	Williamson County Catholic Credit Union	6,189
501(c)(15)	Mutual insurance companies or associations	Providing insurance to members substantially at cost (limited to organizations with gross income of $150,000 or less).	Sand-Clay Mutual Burial Assoc.	910

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(16)	Cooperative organizations to finance crop operations	Financing crop operations in conjunction with activities of a marketing or purchasing association.		18
501(c)(17)	Supplemental unemployment benefit trust	Payment of supplemental unemployment compensation benefits.	Dayton Malleable Iron Company, Ohio Malleable Div.	702
501(c)(18)	Employee funded pension trust	Payment of benefits under a pension plan funded by employees (created before June 25, 1959).		5
501(c)(19)*	Post or organization of war veterans	Activities implied by nature of organization.	American Legion Posts	24,815
501(c)(20)	Trusts for prepaid group legal services	Forms part of a qualified group legal service plan or plans. (Applicable to taxable years beginning after December 31, 1976).		202
501(c)(21)	Black Lung Trusts	Satisfies claims for compensation under Black Lung Acts. (Generally, applicable to taxable years beginning after December 31, 1977).		21
501(c)(22)	Pension Trust	Pension plan withdrawal liability trust created to provide funds to meet payments under section 4223(i) or (j) of ERISA.		0
501(c)(23)	Veterans' insurance associations	Provide insurance and other benefits to member veterans.		0
501(c)(24)	Trusts	Described in ERISA section 4049.		0
501(c)(25)	Title holding companies	Those with 35 or fewer entities exempt under IRC section 401 and 501(c)(3) and governmental units.		0

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(d)	Religious and apostolic associations	Regular business activities; communal religious community.		84
501(e)*	Cooperative hospital service organizations	Enumerated cooperative services for hospitals.		79
501(f)*	Cooperative service organizations of operating educational organizations	Collective investment services for educational organizations.		1
			TOTAL	865,653

* Generally, contributions under this Code subsection are tax deductible. Other organizations not asterisked could establish trusts under Code subsection 501(c)(3) which may receive tax deductible contributions.

NOTE: Examples are not shown for organizations tax-exempt under Code subsections 501(c)(11), (16), (18), (20), (21), 501(d), 501(e), and 501(f) because there is very little activity.

NOTE: Number of organizations is a count of the number of active entities on the IRS Exempt Organization/Business Master File as of April 30, 1987.

Table 1

Sources of Nonprofit Support by Subsector, 1984

Type of Nonprofit Organization	Total Revenues	Private Contributions 1/	Government	Dues, Fees & Charges	Endowment & Other
Health					
$ billion	$125.7	$17.4	$44.5	$60.8	$3.0
percent	100%	13.8%	35.4%	48.4%	2.4%
Education & Research					
$ billion	$57.1	$11.8	$9.7	$30.5	$5.0
percent	100%	20.7%	17.0%	53.4%	8.8%
Religious Organizations					
$ billion	$28.8	$24.8	-	-	$4.0
percent	100%	86.1%	0%	0%	13.9%
Social Service 2/					
$ billion	$21.8	$8.3	$9.6	$2.8	$1.1
percent	100%	38.1%	44.0%	12.8%	5.0%
Civic, Social and Fraternal					
$ billion	$7.0	$2.2	$3.5	$0.9	$0.4
percent	100%	$31.4%	50.0%	12.9%	5.7%
Arts and Culture					
$ billion	$6.9	$4.6	$0.9	$0.7	$0.7
percent	100%	66.7%	13.0%	10.1%	10.1%

Department of the Treasury
Office of Tax Analysis

June 19, 1987

Source: Dimensions of the Independent Sector, 1986, Table 4.1.

1/ Including contributions from churches.
2/ Including legal services.

Note: Foundations are excluded.

Note: Detail may not add to totals due to rounding.

Table 2

Nonprofit Charitable Organizations

Components of Revenue as Percent of Total Revenue by Asset Size, 1983

Asset Size	Private Contributions	Government Grants	Dues & Assessments	Program Service Revenue	Other
Under $100,000	23.2	42.0	6.4	20.6	7.8
$100,000--$499,999	18.7	34.4	5.2	34.3	7.4
$500,000--$999,999	22.8	40.8	2.0	26.7	7.7
$1,000,000--$9,999,999	17.0	13.2	2.0	55.4	12.4
$10,000,000--$49,999,999	11.0	4.5	1.2	72.9	10.4
$50,000,000 or More	6.5	5.9	0.7	73.0	13.9

Department of the Treasury
Office of Tax Analysis

June 19, 1987

Chairman PICKLE. I think we will ask Commissioner Gibbs to proceed with his testimony and then the committee, I am sure, will have questions for both of you as a panel so Commissioner Gibbs, if you will proceed.

STATEMENT OF HON. LAWRENCE B. GIBBS, COMMISSIONER OF INTERNAL REVENUE, ACCOMPANIED BY ROBERT I. BRAUER, ASSISTANT COMMISSIONER FOR EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS

Mr. GIBBS. Thank you. Mr. Chairman and members of the subcommittee, I am pleased to be here today to discuss the administration by the Internal Revenue Service of the unrelated business income tax and I will restrict my remarks to the area of administration of the unrelated business income tax and attempt to avoid duplicating the remarks that Mr. Chapoton has made. With me today is Mr. Robert I. Brauer. Mr. Brauer is the Assistant Commissioner for Employee Plans and Exempt Organizations who currently has responsibility for the exempt organizations programs of the Internal Revenue Service.

In recent years, we have seen a great deal of growth in the number of tax exempt organizations and in the scope of their activities in this area. Going back not quite 20 years, to 1968, our exempt organization master file at that time included a little over 400,000 entities. For 1986, our master file data showed that we have somewhere between 850,000 and 900,000 active exempt organizations and that figure does not include most of the churches.

Now, these exempt organizations are divided into about 25 different categories; the most significant one of which are the so-called charitable or 501(c)(3) organizations constituting almost 50 percent of the total number of entities.

With this general background, I would like to focus my comments today on two parts of our tax administration efforts. First, I would like to discuss our examination of exempt organization business income tax returns and second, I would like to discuss some of the issues with respect to the statutory provisions in this area as they affect the administration of the tax laws.

Generally, with the exception of churches and certain other types of organizations, if a tax exempt organization has gross receipts in excess of $25,000, it must file a return, the form 990. Additionally, if the tax exempt organization has unrelated business gross income in excess of $1,000, it must file another type of return, a form 990–T. Now, in calendar year 1986, the Internal Revenue Service examined about 20,000 exempt organizations having filed form 990 returns and that is approximately five percent of the total number of organizations that filed 990 returns during calendar year 1986. During the same period, the Service examined about 3,000 forms 990–T, or in excess of 10 percent of the total forms 990–T that were filed for that period.

We submit, that given a 5-percent coverage overall, with respect to the forms 990 that are filed by exempt organizations, and in excess of 10 percent of the 990–T's, it appears to us that there is a sufficient audit coverage in this area. Under our present procedures, the forms 990–T, those that report unrelated business taxable income, are examined only in conjunction with our examination of the related forms 990, which are filed by exempt organizations. We focus our examination selection process, therefore, on the form 990's that are filed by exempt organizations and in connection with the review of those forms, we then determine if a form 990-T, reporting unrelated business taxable income, has been filed or should be filed.

Now the General Accounting Office has reported to this subcommittee, that we, at the Internal Revenue Service, could improve our process of selecting unrelated business income tax returns for audit. Specifically, the GAO has suggested that we gather more statistical information on noncompliance in this area, in order to more systematically select returns that have potential for noncompliance and therefore, potential for tax on unrelated business income. We agree with the GAO recommendation in this regard and within 4 months, we will begin a taxpayer compliance measurement program survey that we have been formulating over the last several years, that is specifically designed to audit the form 990-T returns, the unrelated business income tax returns of exempt organizations.

In addition, we are also selecting statistical samples of unrelated business income tax returns and other relevant data, to develop interim information that we think will assist our examination program in this area. I will not repeat the statutory history that Mr. Chapoton has described. I will simply note that after the legislation in 1950, and after the legislation in 1969, we have a fairly complicated structure for our unrelated business income tax. In preparation for this hearing, I reviewed the many exceptions, exclusions, exemptions, and limitations to the unrelated business income tax, that have developed over the years. There are a number of code sections in section 512 and also in section 513 that are specific exceptions to the unrelated business income tax. While I have no quarrel with the right of Congress to exempt certain income from tax, I would hope that as we begin to review this area, an attempt could be made to take a look at the definition of unrelated business income, and hopefully, to avoid, in the future, a piecemeal repeal of the unrelated business income tax.

Now, the Internal Revenue Code defines unrelated trade or business as a trade or business that is regularly carried on and that is not substantially related to an organization's tax exempt purposes. There are three exceptions and I will not dwell on them. Mr. Chapoton has discussed them. Namely, the activities where all the work is performed without compensation by volunteers. The second one being activities that are performed by organizations primarily for the convenience of members or employees, patients, students, et cetera, and third activities involving the sale of merchandise, substantially all of which have been received as a gift. In approaching the administration of the unrelated business income tax, in addition to these three exemptions, there are a number of provisions where application of the tax requires a very subjective decision that is based on the facts and circumstances of each case. Again, I will not go into them in detail other than to mention them and to express my opinion that they do cause administrative difficulties for the Internal Revenue Service. Specifically, the determination of whether an activity is or is not substantially related to an exempt purpose. Again, this has been a difficult area for us in making decisions that require an examination of the relationship between the income-producing activity itself and the accomplishment of the exempt purposes of the particular organization.

We will also note that another difficulty that we have experienced in this area, is determining whether an activity is regularly carried on. Again, if there is a business activity but it is not regularly carried on, then it does not give rise to the unrelated business income tax issue. If it is regularly carried on, it does. And it is often difficult to make distinctions in this area from an administrative standpoint. Third, and finally, we have difficulty in dealing with the problems, some of which Mr. Chapoton outlined, involving the allocation of expenses and income between exempt and nonexempt activities. Suffice it to say that despite successes in recent court decisions in this area, this still is an area that proves difficult for us administratively.

Now, in reviewing statutory changes in this area, I would like to express my concerns about proposals suggesting that unfair competition should become a statutory test. Currently, the statute and regulations do not require the Service to consider competition in determining exempt status or the application of unrelated business income tax. Also, our forms do not require information reporting concerning competition. The Service has neither the data nor the expertise to determine the degree of competition that would require a determination of whether or not that competition is unfair.

I would like to conclude by indicating those areas in which the Service believes that we can make a contribution to solving some of the issues and problems in this area.

Specifically, we believe that we can improve the reporting on the forms 990 and 990-T through clarifying the reporting requirements on the form 990 regarding business activities including businesses that are conducted through subsidiaries and also through simplifying the reporting of unrelated business income and expenses. We also believe that we can make a contribution by improving taxpayer education through expanded taxpayer information publications and through an illustrative form 990-T, particularly for smaller organizations and other organizations that do not use professional return preparers. And finally, we are attempting to improve our administration in this area by improving our data collection through increasing the sample size of our current statistical studies, conducted by the Statistics of Income personnel on private foundations and other section 501(c) organizations.

And finally, as I mentioned, by conducting studies of exempt organizations unrelated business incomes for every other year, beginning this year.

To summarize, the Service believes it maintains a significant audit presence in the area of the unrelated business income tax. We are, however, currently engaged in implementing the GAO's recommendations and some of our own initiatives in this area, to do a better job. Additionally, we believe that improvements should be considered in applicable code provisions, in the structure and format of forms 990 and 990-T and in the provisions for additional taxpayer education and assistance. In proposing legislative changes, however, the Service would not recommend codifying the unfair competition as a statutory test.

Mr. Chairman, Members of the subcommittee, this concludes my oral presentation and I will be delighted to answer any questions that you may have.

[The prepared statement follows:]

TESTIMONY OF
LAWRENCE B. GIBBS
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
HOUSE WAYS AND MEANS COMMITTEE

JUNE 22, 1987

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the administration by the IRS of the Unrelated Business Income Tax. As you noted in your May 14th news release, the administration of the unrelated business income tax is a matter of importance to tax-exempt organizations and for-profit businesses alike. It is also a key feature of our overall exempt organizations program, and I commend the Subcommittee for holding this comprehensive review of the area.

With me today is Robert I. Brauer, Assistant Commissioner (Employee Plans and Exempt Organizations), who has responsibility for the exempt organization programs within the Service.

Background

In recent years, the growth in the number of tax-exempt organizations and in the scope of their activities has presented a challenge to our tax administration efforts in this area. In 1968, our exempt organization master file included approximately 410,000 entities. Master file data for Fiscal Year 1986 shows that there are currently approximately 900,000 active exempt organizations, and that figure does not include most churches.

Exempt organizations are divided into 25 categories ranging from those organized for charitable, educational, scientific and religious purposes to trusts for payments under the Black Lung Act. However, charitable and educational organizations exempt under section 501(c)(3) constitute the largest group and were approximately 43 percent of all listed exempt organizations in 1985.

With this background, I would like to focus my comments today on two parts of our tax administration efforts. First, I would like to discuss our examination of Exempt Organization Business Income Tax Returns. And finally, I would like to discuss the current statutory provisions in this area.

Examination of Exempt Organization Business Income Tax Returns

With the exception of churches and certain other organizations, tax-exempt organizations with annual gross receipts in excess of $25,000 must annually file a return of Organization Exempt from Income Tax, Form 990. Additionally, tax-exempt organizations with unrelated business gross income in excess of $1,000 must also file an Exempt Organization Business Income Tax Return, Form 990-T.

In calendar year 1986, the IRS examined about 20,000 exempt organization returns or about five percent of the total Form 990 filings. In the same period, the Service examined about 3,000 Forms 990-T or in excess of 10 percent of the total Form 990-T filings. Based upon these figures, it is apparent that the Service does not need additional examination resources in this area beyond what has been budgeted.

Generally, Forms 990-T are examined only in conjunction with the examination of a related Form 990, or 990-PF, Return of Private Foundation. We currently focus our exempt organization examination selection process on the Forms 990 and 990-PF because all business activity is required to be reported on them and allocation of income and expense issues stem from them. Once the Form 990 or 990-PF is selected for examination, the agent also determines the organization's liability for unrelated business income tax and examines any related Form 990-T. During the examination process, the agent sometimes finds that a Form 990-T was due and yet was not filed. The agent's responsibility then is to secure the delinquent return. During fiscal year 1986, 37% of the Forms 990-T examined by the Service were delinquent returns.

The GAO has reported to this Subcommittee that the IRS could improve its process of selecting unrelated business income tax returns. Specifically, the GAO has suggested that the Service begin to gather more statistical information on noncompliance in this area in order to systematically select returns having the most potential for noncompliance.

We agree with the GAO recommendation and are currently gathering the appropriate statistical information. Beginning in fiscal year 1988, we will begin a Taxpayer Compliance Measurement Program (TCMP) survey of unrelated business income tax issues. Additionally, we are currently selecting statistical samples of unrelated business income tax returns and other relevant data to develop interim information which will be helpful in structuring our examination program.

Once this information has been obtained, we are confident that we can improve our selection of returns for examination. A better selection process combined with the type of examination coverage percentages which we are now experiencing will provide for an even more effective examination program.

The Statutory Provisions

In 1950, the Congress enacted the first legislation imposing a tax on unrelated business income. While previously there had been attempts to deal with the problem of unfair competition, this was the first comprehensive legislative action taxing such income. The purpose of the legislation was to minimize any unfair competitive advantage various exempt organizations had over commercial entities and to prevent a loss of revenue to the Treasury. This unrelated business income tax was originally applied to only section 501(c)(3) organizations (excluding churches), section 501(c)(5) Labor, Agricultural and Horticultural Organizations, section 501(c)(6) Business Leagues and trade groups, section 401 Employees' Trusts and a few other minor categories of Exempt Organizations.

For almost 20 years, no major changes were made to the statutory scheme. In 1969, Congress expanded the tax to cover all section 501(c) organizations (except section 501(c)(1) federally chartered organizations). Since 1969, almost every tax law passed has contained unrelated business income tax provisions.

In my preparation for this hearing, I reviewed the many exceptions, exclusions, and limitations to the unrelated business income tax that have been enacted over the years. These have been done on an ad hoc basis, frequently to overturn IRS tax determinations.

Examples include Section 513(h)(3) which excludes income from certain mailing list rentals and exchanges; Section 512(b)(15), which excludes income received by a certain religious order from operation of a commercial television station; Section 513(d)(2), which excludes income from certain horse races with pari-mutuel betting; Section 513(d)(3), which excludes income from trade show activity; Section 513(f), which excludes income from many bingo games; Section 513(g), which excludes income from certain pole rentals; and Public Law 94-455, which excludes income from operation of an orange grove provided that it is contiguous to an old age home.

While I have no quarrel with the right of Congress to exempt certain income from tax, I would hope that in the future an attempt could be made to define unrelated business income in a way that would avoid the impression of a piecemeal repeal of the unrelated business income tax.

The Internal Revenue Code defines an unrelated trade or business as a trade or business, regularly carried on, that is not substantially related to the organization's tax exempt purposes. Certain types of activities are specifically exempted from these definitions and they are:

1. activities where substantially all the work is performed without compensation;

2. activities performed by a charitable organization primarily for the convenience of members, employees, patients, students, etc.; or

3. activities involving the sale of merchandise substantially all of which was received as a gift or contribution.

Unrelated business taxable income is defined as gross income from unrelated business activities less allowable deductions that are directly connected with such activities. Certain income is specifically exempted from such gross income such as nominally passive income like dividends, interest, annuities, royalties and capital gains. Additionally, there are exemptions for specific activities such as university or hospital research income. Once unrelated business taxable income has been determined, the applicable tax is calculated in accordance with the corporate and trust tax rules.

Interpretative and Enforcement Difficulties

Many of the provisions for applying the tax require a very subjective decision based on the facts and circumstances of each case. For instance, facts and circumstances decisions must be made concerning:

1. Whether an activity is "not substantially related" to an exempt purpose - The presence of this requirement necessitates an examination of the relationship of the income producing activity and the accomplishment of exempt purposes. The business activity must contribute importantly to the accomplishment of exempt pruposes, other than through the production of income. Whether the relevant relationship exists depends on the facts and circumstances of each case. Moreover, income producing activities which are carried on within a larger group of similar activities may be "fragmented" and treated separately for unrelated business income tax purposes.

   In the case of a museum shop, based on all facts and circumstances, the Service ruled that the sale of a teddy bear was a substantially related activity where it was identified as a model of the stuffed toy named after

Theodore Roosevelt, and because it introduced children to American history and President Roosevelt. On the other hand, the sale of blazer buttons adapted from a medal commemorating George Washington's First Inauguration was held to be an unrelated activity because of the utilitarian purpose of the buttons. However, the ruling indicated that if the blazer buttons were sold with descriptive literature explaining their connection with the original medal, the sales might then be considered related activity. Such fine distinctions are illustrative of the types of problems encountered when our agents and tax law specialists are required to apply the "not substantially related" test in a given case.

2. Whether an activity is regularly carried on - A specific business activity of an exempt organization will be deemed to be "regularly carried on" if it occurs with frequency and continuity and is pursued in a manner comparable to commercial activities of non-exempt organizations. Thus, the operation of a parking lot one day a week throughout the year is "regularly carried on", but an annual dance for charity is not.

3. How to allocate expenses and income between exempt and nonexempt activities - Once the above definitional issues are resolved, difficult allocation and accounting problems often remain in determining the appropriate income and expenses to be taken into account in order to compute unrelated business income. An example of the allocation problem is a recent court decision relating to the computation of the unrelated business income tax on the net advertising income of an exempt periodical. In that case, the court allowed the charitable expenditures of an affiliated section 501(c)(3) fund to be taken into account in determining the expenditures attributable to the association's section 501(c)(6) activities, thereby minimizing its net income subject to tax.

   In another recent case, the court dealt with the computation of unrelated business income tax on the income from the commercial use of an exempt university's ice-skating fieldhouse. In that case, the court premitted the university to allocate its fixed expenses on the basis of actual use of the field house, rather than total availability. The result of this decision, as a practical matter, is to provide exempt organizations with an opportunity to maximize the allocation of expenses allocable to unrelated business activities and thereby reduce the amount of unrelated business income tax.

While discussing interpretative and enforcement difficulties, there is also a positive side that the record should reflect. Last year the Supreme Court considered two fairly common unrelated business income questions in the American College of Physicians and the American Bar Endowment cases. The Court overturned both lower court decisions. The Court determined that the American College of Physicians had unrelated business income to the extent of income from pharmaceutical and other advertisements in its journal. In that case, the business of selling advertising space was determined to be not substantially related to the organization's exempt educational purpose. In the other case, American Bar Endowment, income from insurance activities was determined to be income from a trade or business not substantially related to the organization's exempt purpose and therefore unrelated business income rather than charitable fund raising as the lower courts had characterized it.

Both decisions are very significant to the Service's tax administration within this area and provide guidance as to what "substantially related" or "trade or business" mean, particularly in the context of advertising and insurance activities.

"Unfair" Competition

In reviewing statutory changes in this area, I would like to express my concerns about proposals suggesting that "unfair" competition should become a statutory test. Currently the statute and regulations do not require the Service to consider competition in determining exempt status or application of the unrelated business income tax. Also, our forms do not require information reporting concerning competition. Very simply, the Service does not have data or the expertise to determine the degree of competition and most particularily whether there is "unfair" competition.

Mr. Chairman, the Service would like to work with you and your Subcommittee on several initiatives. Specifically, the Service is currently beginning to take a look at the following objectives.

1. Improving reporting on the Forms 990 and 990-T through --
    a. clarification of reporting requirements on Form 990 regarding business activity including business conducted through taxable subsidiaries, and
    b. simplification of reporting of unrelated business income and expenses,
2. Improving taxpayer education, through expanded taxpayer information publications and an illustrative Form 990-T, particularly for the smaller organizations and other organizations not using professional return preparers;
3. Improving data collection through -
    A. Increasing the sample size of our current statistical studies on private foundations and 501(c) organizations, and
    B. Conducting studies of exempt organization unrelated business income at least every other year, beginning 1987.

Conclusion

In summary, the Service maintains a significant audit presence in the area of unrelated business income tax. The dynamic nature of the tax-exempt community, however, will continue to challenge the Service to gather more detailed information in order to structure a more effective examination program. We are currently engaged in implementing GAO's recommendations and our own initiatives in this area.

Additionally, improvements should be considered in the applicable code provisions, the Forms 990 and 990-T, and in taxpayer education and assistance. In proposing legislative changes, however, the Service would not recommend codifying "unfair" competition as a statutory test which would preclude the tax-exempt status of activities. Currently, the Service does not have the data or the expertise to make decisions relative to whether or not there is "unfair" competition in any particular case.

Mr. Chairman, Mr. Brauer and I will be happy to respond to any questions that you or the other Members of the Subcommittee may have.

Chairman Pickle. Thank you, Commissioner, and thank you, Mr. Secretary. I think we would all agree that this is a very complex and difficult area and that there is a very unclear gray line between unrelated or related business activity. The question is can we improve the administration or should we change the statute to make it more clearly workable. Now, Mr. Secretary, you had said in relating the history of the law that in 1950 and again in 1969 this law came into being and was increased or strengthened because there was an effort made to try to prevent unfair competition. That seems to be the basis of the law. Mr. Gibbs, you also indicate the same background. That was the historical reason why we tried to set this UBIT law on the books. But Mr. Commissioner, you say you do not want unfair competition used as a test by statute. Whether we use it by statute or not, I think we would all agree that it is a basic background concern of ours, the Congress, in trying to regulate this activity. Would you agree with that?

Commissioner Gibbs. I would. I spoke, Mr. Chairman, from the standpoint of determining whether something is fair or unfair. If we can define, statutorily, what we mean by fairness or unfairness, which is largely the thrust of the statutory definition that we have, then I think we would feel more comfortable than simply an abstract statutory definition that would leave us in the uncomfortable position of attempting to determine when competition was and was not unfair.

Chairman Pickle. I am not recommending that we have a statutory definition although I think it is a legitimate question we must ask ourselves. If we can statutorily define what is substantially related, we could also grapple with a similar problem. I am surprised, and I said in my testimony, that there seems to be a lack of review of many of these activities. Now, you indicated that 5 percent of the total number of exempt forms have been reviewed. I do not know that I understand your figures. We have in the neighborhood of 850,000 to 900,000 of these organizations. You did not actually review but about 3,000 of the 27,000 total UBIT returns, that is, 990-T's, is that correct?

Commissioner Gibbs. Let me clarify the figures if I can. Mr. Chapoton mentioned that we estimate that if you include churches and all of the organizations, whether or not they are required initially to file an application for exemption, there are some 1.2 million exempt organizations. When we look at the number that we have actually received communications from in some form and have on our exempt organization master file, it is around 900,000. Now, when you take a look at those exempt organizations that are required to report to us annually, and recall that churches are not required to report annually, and also recall that unless an organization has more than $25,000 in gross receipts, it is not required to file annually, you come down to an annual filing, Mr. Chairman, of about 400,000. And out of the 400,000 we find that on the average, we have about 27,000 that file a 990-T and reflect that it is required because they have unrelated business income, gross receipts in excess of $1,000. Those are the numbers and when I mentioned the 5 percent figure, they are keyed to the 400,000 annual 990 reporting forms that an exempt organization is required to file.

Chairman PICKLE. I said, in my opening statement, that according to the GAO report, that of 3,224 unrelated business income returns which the IRS examined last year, only two organizations counted about 60 percent of the total. What were those two? Are they a matter of record?

Commissioner GIBBS. I do not know that they are a matter of record. I do not believe they are because of the disclosure laws but if you wish, Mr. Chairman, we can, in executive session or otherwise, provide you with that information.

Chairman PICKLE. They have been examined and finalized so it is a matter of fact that you have collected that much money so there is no question about who they are?

Commissioner GIBBS. That is correct.

Chairman PICKLE. But you cannot reveal that to this Committee?

Commissioner GIBBS. Yes, sir, that is correct.

Chairman PICKLE. Well, we would like to know those as a matter of background. Now, Mr. Secretary, let me ask you first to begin with, I want to say that you have given us about seven different suggestions and recommendations and you have gone into some detail and explanation of them. I guess the first question I would want to ask you is do you think that the present laws which we have on the books today, are adequate to express an appropriate tax policy. Is the present law adequate?

Mr. CHAPOTON. Mr. Chairman, I think that it is very difficult to answer broadly whether it is adequate in all respects. I think it really requires some judgments about just what we want to accomplish by the tax exempt law, what activities we want to exempt. As I indicated, I think the basic purpose of the tax exemption is to encourage certain activities and I think that would have to be the activities which we would think cannot be adequately performed both either quantity-wise or quality-wise by the commercial sector. And in defining what is unfair competition or fair competition, I think we have to keep that general purpose in mind because there is going to be some competition.

Having said that, how you define statutorily in what circumstances the goods or services are not adequately provided by the commercial sector is a difficult determination. It appears that if the tax exempt purpose of an organization is a worthwhile function such as education, religious activities, or certain scientific activities, and if all of its activities are sufficiently related, we think that the general concept is working. Thus, we think the general principles are working. We are not saying, though, that this should never be evaluated as to whether the tax exemption is too broad, we do not think it has been examined very closely in a number of years and some of these hearings might indicate some reexamination of those basic principles.

Chairman PICKLE. Starting on page 19 of your testimony, you proceeded to make comments in seven different areas. Now these are substantial recommendations for changes. Whether we could change them administratively or by statute, they will require a great deal of thought and effort because I take them to be very substantial changes that would be expected to be made by statute. Do you agree with that?

Mr. CHAPOTON. Yes, Mr. Chairman. But I think that we need to be cautious that we are not recommending these changes; we are recommending that these questions be considered and studied. For example, take the very basic question of the relatedness test, whether an activity contributes importantly to the tax exempt purpose of the organization. We are not saying that test should be changed. We are saying it should be examined. We think there are difficulties in applying it. We do not know whether that test is being abused to any significant degree on the data that we now have, but I think that applies to most of our suggestions. We are raising areas which, based on the information we have, raise questions in our mind, and in some cases, we are able to say we think some changes should be made.

Chairman PICKLE. I do not know that I understand what you are driving at. You say there are serious questions and recommendations, but you are not making them as specific recommendations for changes but something for us to consider.

Mr. CHAPOTON. And for us to consider. We would like to study it with you.

Chairman PICKLE. Well, I appreciate that. I do not know how much that helps me because I think I understand the problem and I am sure the committee will want to take it under consideration. But, when you make the recommendation on passive income that it is an accepted principle and we ought not to tax passive income, but it should be taxed if it was a social organization's and that we ought to give consideration to it. Now, that is a fine general statement. Yet when you say that, then that means you are saying that we ought to tax Lion's Clubs, Sierra Clubs, Rotary Clubs, Common Causes, or Mr. Roosevelt's Social Security group. So I find it is not enough to say that we ought to consider them, but I would hope that we would be able to work with you on specific recommendations as to how we change it. If you raise the question, then I would like to know more specifically, how you think we can go about this.

Mr. CHAPOTON. Mr. Chairman, one point in raising that issue is we would like to hear from those organizations as to the justification or the reason——

Chairman PICKLE. We have heard from them and you will be hearing from them if you have not. But we hear from them first, directly, and that is to be expected because as we examine this question the whole sphere has to be examined at the same time. I am glad you made these suggestions and these recommendations. I would hope that we will look at them to determine if they are practical and which ones the committee can agree on. Specifically, the suggestions we have from you in addition to what you have said here as a general principle, obviously are directed at problems, whether you are talking about a substantial relationship or whether you are talking about the scope, the volunteers, or the subsidiaries.

All of these are serious questions and I think they need to be corrected. We would hope that we can work with you closely as we examine these to see what we really can do. I think that our staff will be talking to you further about specific examples in each one of these areas, the seven areas that you suggested to us, though you did make some comments. What would be the best way to achieve more meaningful public disclosure and accountability?

Mr. CHAPOTON. That is, again, a tough question. Accountability, right now, seems to be somewhat limited. It is limited to the IRS examining these organizations by its usual audit process to see if they are engaging in activities which are permitted in connection with their tax exemption. We wonder if that is far enough, for example. Whether, for example, that ensures that the nature of the activity is being performed efficiently. When the contributions are made to an organization, is the money being spent wisely and things of that sort. We do not think that it is an IRS or a tax policy function and we are not really suggesting it as a matter of tax policy; we are simply raising it because we think that the IRS examination does not go that far and so there is no accountability of those organizations in the same sense there is of commercial organizations which have shareholders and board of directors accountable to those shareholders.

Chairman PICKLE. I asked the Commissioner earlier if he thought we ought to quote unfair competition or words to that effect, as we consider these possible changes or at least reasons for the changes. And I would ask you, has the question of whether a tax exempt organization activity is conducting a trade or business depended upon whether the entity is in competition with taxable organizations? Do you have any views about the fact that we should look or not look at unfair competition?

Mr. CHAPOTON. Well, I think that looking at unfair competition is appropriate. I think, though, that you immediately get into the definition of what is unfair competition. There is simply no question that every time a tax-exempt organization engages in a business activity, it is competing with taxable organizations. You can say that whether it is the ballet company that sells tickets in competition with a commercial Broadway show, or whether it is a college dormitory that is in competition with a profit-making apartment building. So I agree with Mr. Gibbs. That is a very tough standard to apply and I think we need to look somewhere else, even if that is the ultimate result we are trying to reach. We need to look somewhere else for the definition of what we are going to permit.

Chairman PICKLE. I have several other questions and, incidentally, we will be submitting to each of you, specific questions, many of them that we will not have time to touch on today, but we want your answers to be responsive and quickly on each one of the questions we asked, as quick as you can. Mr. Frenzel, do you have questions you would like to ask either of these gentlemen?

Mr. FRENZEL. Mr. Chairman, I would like to start with a short statement of endorsement to you for pursuing these hearings. As you have indicated, it has been several decades since Congress has reviewed this matter other than on a piecemeal basis. We have seen already in the initial testimony that it is a complex area which confuses some of the major players and policymakers. Congress has to look at it to see if the Government is getting its fair share of taxes. We have to be aware of the problems of small businesses who may pay taxes and who may be facing unfair competition. But we also have to look at it from the point of view of the charities and our traditional endorsement of their efforts and be, in my judgment, slow to make changes unless we can see a good reason to make them.

I hope that the subcommittee will exercise great care and I am particularly pleased with the testimony that has been presented so far. Secretary Chapoton, that was a real tour de force that you gave us and served only to complicate my life by serving up options. You kept saying that well, here is an area that Congress will have to consider and we like to have others do our considering for us, but it was just a splendid piece of work. I have a question for Commissioner Gibbs. How do you react to taxpayer complaints about competition? Do businesses come to you and say, here is a church or somebody that is intruding into my tour business and that is unfair competition and I want you to make them pay taxes? Do you get those kinds of complaints?

Commissioner GIBBS. Mr. Frenzel, we do.

Mr. FRENZEL. What do you do with them?

Commissioner GIBBS. Oftentimes they are not just complaints, they are allegations that an exempt organization is engaging in an unrelated business activity that is competitive. As the information comes in, we process it as we do any other type of information along these lines. We will receive it, we will review it. If it comes into the National Office, we will send it to the appropriate district where it will be assigned to an examining agent for review, to determine whether there is merit in the contention and whether it ought to be reviewed in connection with an audit of an organization or be sufficient to involve the audit of an organization. But we do review the complaints that we receive and try to direct them to the appropriate place within the organization to make that kind of determination.

Mr. FRENZEL. Now, I expect that under the current law and the current case, that most of the time you are not able to assess UBIT. Is that correct, as a result of these complaints?

Commissioner GIBBS. In many cases, the complaints that we receive, go to the issue of whether there is competition or not. And as Mr. Chapoton has said——

Mr. FRENZEL. That is not one of the points of the law?

Commissioner GIBBS. That is correct. Quite often, the complaint is simply one of competition as opposed to the issue of whether it is competition that should make a difference from the standpoint of the organization reporting and paying tax on the unrelated business income, if it is, indeed, unrelated.

Chairman PICKLE. Will the gentleman yield?

Mr. FRENZEL. I do.

Chairman PICKLE. I think we would all agree, though, when a business complains whether it is fair or unfair, they do not sit down and write the Secretary of the Treasury a letter, explaining their concern. They sit down and write their Congressman, or their Senator, and we are the ones to hear, much more promptly than you will, a hundredfold more, and that is normal. So while you may or may not get a lot of direct complaints, I can assure you that those complaints are received up here and we should understand that.

Commissioner **Gibbs**. Mr. Chairman, I do understand that. I also assume that in many cases, as you receive those letters from your constituents, you are sending them on to us to review or comment or do something with.

Chairman **Pickle**. Yes, I guess we do that and the Congress also——

Mr. **Frenzel**. And sometimes they come back.

Chairman **Pickle**. You did not mention in your statement but I noticed a paragraph you had in there that we have given a lot of exceptions by congressional actions. Quite often, when a tax bill is passed, we slip in there an exemption for this organization or that organization. So the Congress must look at itself also to make the changes but we constantly are granting exceptions because at the time, they appeal to us. I believe your appeal to us is to not have a fragmentation or a piecemeal approach on this. That is one reason why we have the hearings. We will admit that we are party to this confusion, the same as the IRS and the Treasury. The Congress has got to also try to be as consistent in our approach as we can, and we have not always been. We should admit that.

Mr. **Frenzel**. I thank the gentleman for his contribution. One of the problems with the complaints is, at least the ones that come over my transom, is that they often include aspects of law other than UBIT. That is, they complain that the organization has volunteer labor or that it does not pay the same fringe benefits, or have the same payroll tax liabilities or does not pay overtime or whatever. Those are, of course, separate from this section of the law but they are important to the small business organization that is making the complaint. The chairman reminds me, Mr. Chapoton, of one feature of law in which the Congress has acted to give a couple of exceptions which is bothering some of the universities in the country with respect to allocation of tickets to contributors to certain funds of the universities. I am told that we have exempted a couple of universities but the others are getting some heat from the Government, perhaps from the Commissioner to be charged UBIT for this kind of practice. Is that the case?

Mr. **Chapoton**. Are you referring to the football stadium?

Mr. **Frenzel**. Well, I am referring to the allocation of seats to contributors.

Mr. **Chapoton**. Well, happily, one of the universities that has been exempted is the University of Texas, which is where both Larry and I attended school.

Mr. **Frenzel**. You took care of your alma mater, but I suppose it is all right.

Mr. **Chapoton**. But, Mr. Frenzel, I think that in the technical corrections bill that has just been filed, that discrimination has been eliminated.

Mr. **Frenzel**. That is extended to all institutions and that is a good thing. I think that is one of the reasons the chairman called the hearing because he was nervous about using piecemeal riders in conference bills. But under the law as you interpreted it, they should have been charged for that kind of allocation?

Mr. **Chapoton**. Well, there is no question that if you are paying for something more, if you are making a contribution, and in the contribution, you are getting something of value, that the contribution should be limited to the amount that you are not paying for the value received.

Chairman **Pickle**. Will the gentleman yield?

Mr. **Frenzel**. I yield to the Chairman.

Chairman **Pickle**. You brought up this subject. The Technical Corrections Act has removed the two schools which were granted the exception. It is still a very unsettled question. How do we handle these kind of contributions, both as a policy and with respect to allocations. Basically, all we should consider is their right to purchase tickets. Nobody gets a free ticket. This hearing is not called for that reason. I think it should be observed, at this point, that either Joint Tax or Treasury estimated that the amount of revenue that would be lost from the Federal Treasury, if this exemption was granted and it would continue like we are, even under the rules proposed by Treasury, the loss of revenue would be but about $8 million. So it is de minimus and I am hoping that we can find even a better answer to settle this question and we are looking for it now.

Mr. **Frenzel**. Did I make a mistake? Does that relate to the amount that is deductible in the contribution rather than to the income of the institution?

Mr. **Chapoton**. Yes, I think it is related back to the deduction. And it is a tough allocation question, Mr. Chairman, I agree with that. It is one that always occurs in this tax exempt area where contributions are made and something of value is received. Even if it is just a dinner for an evening.

Mr. **Frenzel**. But it points up the difficulty of allocation in any of these areas. You seem to be, Mr. Secretary, concerned about a couple of cases, *Plumstead, Rensselaer,* and so on, that you feel are not right. Not you, but the Treasury, has the reputation of coming up here every time it loses a case and demanding that we change the law to fit the Treasury's concept of the law. Do you believe, does Treasury believe, that those cases are obsolete or they were not based on a proper understanding of the law, or what?

Mr. **Chapoton**. Well, I do not think that they are obsolete because they are both very recent cases. The *Rensselaer* case dealt with the allocation of expenses to a commercial activity. In that case, I think it was a skating rink owned by the university, and we simply think that that allocation is a difficult matter anytime a tax-exempt entity engages in a commercial activity, because there are certain expenses it is going to incur—fixed costs it is going to incur whether or not it has that commercial activity. So that the unrelated business income tax really does not work very well if it can engage in a commercial activity on which it would pay unrelated business income tax but eliminate that tax liability by the allocation of expenses which it would incur anyway.

Now, we are not saying that it is being abused to that extent, but that result can occur unless the allocation is done properly. And where the primary purpose of an organization is for tax exempt activities, and it is incurring those fixed costs for the tax exempt purpose anyway, we think that it is not appropriate just to count, as the *Rensselaer* court did, the total hours used for tax exempt and the total hours used for commercial purposes and make an allocation on that basis. Because the fact is that all of the remaining unused time is really time that was intended for tax exempt purposes. That has to be the basic proposition.

Mr. **Frenzel**. Okay, so you are just telling us to review the *Rensselaer* case?

Mr. **Chapoton**. That is correct.

Mr. **Frenzel**. And if we feel the irresistible urge to improve on it, we should.

Chairman **Pickle**. Will the gentleman yield again?

Mr. **Frenzel**. I do.

Chairman **Pickle**. Would the gentleman yield. In that connection, since you are talking about the allocation, I understand, Commissioner Gibbs, that the IRS has been reviewing and analyzing as much data as you could in recent months. I am interested in what you have learned particularly with respect to what type of organizations are engaging in the most income-producing activity.

Now, since the allocation has been raised, it has been reported to us that in 29 cases where tax-exempt organizations reported $2 million or more in taxable and unrelated income, that zero tax was owed.

Now if that is the case, is that because of the current allocation rules? Can they just find ways not to pay?

Commissioner **Gibbs**. Mr. Chairman, I think there are a variety of reasons for it, but I would like to underscore the importance of what Mr. Chapoton has said in response to Mr. Frenzel's question.

We find, from an administrative standpoint, that the allocation issue is a particularly difficult one. I would also observe it is an issue that does not confront for-profit organizations.

In the case of a charitable organization, or an exempt organization, when it has unrelated business income it must, in some fashion, come up with a net income figure. In doing that you have to allocate your expense items between your exempt functions and your unrelated business income functions.

We have found that these issues are particularly difficult issues for us in administering the law, and we find that, occasionally, we are confronted with results that seem to us to be inappropriate. Mr. Chapoton has mentioned several.

But I do want to emphasize the administrative difficulties in terms of dealing with these allocation issues. They are significant and they can affect the amount of tax that is otherwise payable or not payable by your exempt organizations.

Mr. **Frenzel**. Thank you. Mr. Chairman, I have more questions, and I suspect maybe we would want to see these witnesses again some time, particularly if we were bringing up information that should not be made available to the public.

But I do have one more. Religious broadcasters are much in the news these days, and there is a very fancy amusement park associated with one of them, with hotels and sales of land, and sales of stuffed billygoats, or branded mascara, or whatever. Under the rules, as you understand them, Mr. Secretary, those operations, should they be subject to UBIT? Or would similar ones run the risk of being subjected to UBIT?

Mr. **Chapoton**. You do not mind if I hide behind a legalistic analysis, do you?

Mr. **Frenzel**. Not at all.

Mr. Chapoton. I think that the question is one of being substantially related in the first place. Whether a theme park is substantially related to a religious activity, whether it might in itself be entitled to an exemption.

I think that that points out one of the difficult questions of interpretation and application. But I might also say we do not know, or I do not know in that case, whether some of the things we have read about are actually being operated in controlled tax-paying subsidiaries. It might well be that they are paying——

Mr. Frenzel. Obviously, we do not know enough about that.

Mr. Chapoton. That is right.

Mr. Frenzel. Another thing bothers me. I have tour agents who complain about competition from organizations. Say that you have a church that is running a tour to Rome, or Jerusalem, or Mecca, or some place. I assume that if it runs it for its members, it might be something they are doing for the convenience of the members.

I also understand that sometimes you do not sell enough seats, and you have to go outside your normal membership, or make available provisional membership. Is that, then, for the convenience of the members?

Mr. Chapoton. Well, you will recall that we raised questions about the convenience of the members test, and I do not know, number one, if those tours are generating a profit. In many cases we are told that they do not.

We do know about the tours you are talking about, but, in many cases, they are merely organizing the tours and using the services of a profitmaking travel organization, we are told. Now, in some cases they are not.

Mr. Frenzel. Yes, except that they may be taking a distributor's package but taking the dealer's discount.

Mr. Chapoton. Well, I understand your point.

Mr. Frenzel. Just as they sell insurance through a large insurance company, but may be taking what the local agent would otherwise provide in the way of services.

I ask these questions because I think they are very difficult, and you cannot just rush out and write a bunch of laws and regulations, and suddenly expect to make everything right.

I think as the world continues to get complex, this problem is going to continue to get worse for us.

Mr. Chapoton. I agree, Mr. Frenzel, and I agree with your comment that we should go very slowly here because this law has built up a long time, people have come to rely on it, and whether it is being abused, or not, is something we simply do not know.

Mr. Frenzel. But I do tend to agree with you, that simply general convenience may be too broad, and maybe there needs to be some necessity along with the convenience to justify the exemption.

Mr. Chairman, we are really just scratching the surface, but I must yield.

Chairman Pickle. I thank you for yielding, and I do want to ask an additional question on TV evangelism.

If television evangelists are subject to the UBIT regulations and law, can you tell me, Mr. Secretary, or Mr. Gibbs, how their witnesses relate to the UBIT, particularly. Are they subject to filing of the 990 and the 990–T?

Commissioner **Gibbs**. Mr. Chairman, one of the preliminary questions you have to answer here is whether the particular organization does, or does not, consider itself to be a church.

If it considers itself to be a religious organization other than a church, then there are required annual filings, form 990, and if it meets the threshold test of a thousand dollars, or more, of gross income, that is unrelated, then it would be required to file a 990-T.

On the other hand, if the organization considers itself to be a church, and does not file a form 990, then, unless it considers that it has unrelated business income, again, of a thousand dollars or more, it would not be filing a 990-T or a 990.

Chairman **Pickle**. Well, Mr. Commissioner, I can appreciate their own interpretation of whether they are, or are not a church. What is your interpretation? What does IRS think? Are they a church, or are they not?

Commissioner **Gibbs**. Mr. Chairman, we are in an area, the difficulty of which is highlighted by a recent Tax Court case decided less than a month ago, in which the Tax Court divided over that very issue.

The case is one that has been discussed recently. We, within the organization, in the last 8 or 9 years, have come up with about 14 different criteria that we use to determine whether or not an organization should be classified as a church.

Chairman **Pickle**. Well what have you determined with respect to the so-called TV evangelist problem that we see and read so much about today?

Commissioner **Gibbs**. It is a situation, Mr. Chairman, where we have to look at each individual one, and believe me, we are doing that.

Chairman **Pickle**. Are you looking into that question?

Commissioner **Gibbs**. Mr. Chairman, as a group, I can tell you that we are looking at a number of issues in this area. I am not able to discuss any specific one in a public forum, although I will be happy to do so, privately.

But we are taking a look at a number of issues in this area.

Chairman **Pickle**. Well, Commissioner, I think it is sufficient to say that the committee intends to ask some of these individuals for testimony, and perhaps we can all examine the situation together, and publicly.

Mr. Rangel.

Mr. **Rangel**. Thank you, Mr. Chairman.

I will not be looking forward to any private testimony, but I think it is safe to say that your testimony today is that there are abuses out there. There are indeed frauds and other criminals that are not paying their taxes, that they are engaged in activities in violation of the spirit of the law, but that generally speaking, you will not make any specific recommendations but there are many problems there that we should be looking at.

My problem is that I have not gathered from either of you gentleman what is the administration's view as to what is sound tax policy, and exactly which areas do we find in unfairness as relates to taxpayers who are required to pay taxes, and other people who are not even required to file, when it is abundantly clear, by any rules of common sense and reason, that these people are not really involved in operating a church, or that the business activities that they are involved in are just wrong and unfair.

Now it is one thing to say what the Congress should not be doing, in terms of piecemeal legislation, but we are a political body and we do react politically.

There are many small museums and tax-exempt organizations that are frightened to death about just these hearings, and they are just thrown in the same general category by your testimony, as though they are the abusers.

My question is, why is it, with all of the tax bills that have come before this committee, that we have received absolutely no recommendations, as I recall, as to how we could close abuse in this area.

Mr. Chapoton.

Mr. CHAPOTON. Well, Mr. Rangel, I think we have trouble identifying areas of abuse quite simply because every time we dig into an area, we do not have sufficient data or information to determine if the competition that we are hearing complained about is caused by the tax-exemption or is caused by some other circumstance.

Mr. RANGEL. Now whose fault is that, that you do not have sufficient information or sufficient data? It just seems to me that every tax bill, IRS is including more requests on their forms than even the Congress can keep up with.

Why is it that we do not know who should be paying taxes, and what they are involved in? And why is it that it is so difficult, even today, to get a recommendation from you?

Do you, Mr. Gibbs, need this Congress to tell you what you should put on your forms in order to get the information that you would need to find out whether or not people who are out there, in business, even though they are tax-exempt and should be paying taxes—can't you just, on your own, request that information?

Commissioner GIBBS. Mr. Rangel, we are indeed beginning to do that. We have been working for the last several years to come up with a taxpayer compliance measurement program survey which we will begin in about 4 months, where we will be examining, a statistical sample of exempt organizations in an indepth way, to attempt to elicit the information that will permit us to better give you information and also administer the law in this area.

Mr. RANGEL. Well, can't you point your Congress at least in the right direction, rather than talking about broad general terms as to the types of tax-exempts that, in your limited opinion, based on limited information, appear to be abusing the system, without identifying who the groups are?

Commissioner GIBBS. I thought that from the standpoint of the areas where we have concern as to the problems, Mr. Chapoton's testimony spells that out in some detail.

In terms of the particular types of entities and areas, I suspect we could do that although the problems he is talking about tend to be generic problems within the area, and the same thing is true of the ones I was discussing.

Mr. RANGEL. But if, indeed, we were talking about the need to allow tax-exempts to be involved in, or not involved in related or unrelated activities, recognizing that they do represent political problems, is not the administration in the best position to state what they believe is sound tax policy, Mr. Chapoton?

Mr. CHAPOTON. Yes, Mr. Rangel, I think we are. I think the problem we really have, though, is determining whether the abuses that get a lot of attention, are caused by the tax law, whether they are unfair competition produced by the tax laws.

For example, the travel type of thing that Mr. Frenzel just referred to. That is a difficult thing to determine, particularly if the unfair competition alleged turns out to be simply a university getting a group together and then hiring a regular travel agent, perhaps getting a group discount.

But there is no tax savings there. There is no tax abuse.

Mr. RANGEL. Well, that is fine-tuning it, but, we have no idea of how much money we are losing because you do not have enough information to determine how much money we are losing out here.

It would seem to me, that once we establish a policy as to what the objectives would be of the tax law, you can throw the ball back in our court to make the hard political decisions as to who would be the beneficiaries, and who would be those that would be the losers. Those are political decisions.

But I do not see the administration coming forth with any policy, and saying what they think we should be doing as it relates to this area.

One of the things that you find very difficult to talk about—you know—we have had crooks in the churches long before this recent TV thing. Why is it that churches are not required to file any returns?

And do you think that is sound tax policy, that you say you are a church, and so therefore, you do not file an annual return?

Commissioner GIBBS. Mr. Rangel, I guess I would turn that question around because this was considered in 1984 when the Congress passed section 7611 of the Internal Revenue Code which specifically deals with the extent to which the Internal Revenue Service can examine a church.

And as in the words of the recent Tax Court decision that I mentioned a minute ago, it is extremely limited in terms of what we can do. We have to have a reasonable belief that there has been a problem of some sort before we can even begin.

Mr. RANGEL. Yes. But there are reasonable beliefs going on, you know, a half a dozen of them every year. It is just that the recent ones are so blatant.

But there is good reason to believe, though, a lot of these people are thieves, and I do not know why we should believe that the IRS is less intelligent than the rest of the country in determining that something is wrong here, and that we should look into why these people are on television, healing people by touching the television, asking for money.

You know, it is against everything that we believe in as a nation. Now, if you do not want to touch it politically, and you cannot make recommendations to the Congress, I can understand that, because it could very well be that many of your recommendations we may find in an election year too difficult to handle ourselves.

But it would seem to me that out of this area that we are going into, that most of your testimony says we do not have enough information, we do not know how much we are really losing, and we do not have a good sound data base, that these are the areas you ought to be looking into.

We are not recommending, we are not even suggesting, but these are things that could cause a lot of problems, and we are glad that the Congress is looking at it. I hope what you do is to challenge this Congress, and this Committee, by presenting to us what makes good policy as relates to what you are supposed to do, and that is to collect the money to provide for the general welfare and defense.

Now the administration had no problem in suggesting to us last year, that just by improving your collection system, that we could collect $17 billion. I think you remember that well, Mr. Gibbs.

And I supported it because I needed the $17 billion for a sales tax deduction, but somehow, it did not fly. Now I am suggesting to you I think there is $20 billion that is lost in this area.

I have no idea as to where I got that figure, but it is probably where the White House got that figure of $17 billion last year. [Laughter.]

And I hope that you can help me to collect this money, so that we can reduce the deficit, and, in order to do that we are going to have to make hard decisions.

I would suggest, however, that if you can bring in the targets as to where you can even recommend that most of the revenue that is lost is being lost, it might make both of our jobs a lot easier.

And I conclude by asking, that when you are able to collect $57 million with the unrelated business income taxes, and half of that came from two organizations, those two organizations, did they tell you how much money they made? Or was this as a result of the investigative probing of the Service? Or did they just report it to you and pay you the taxes?

Commissioner Gibbs. Mr. Rangel, let me clarify that those figures are taxes assessed by the Internal Revenue Service, not taxes collected as a result of our audit activity.

And I believe they occurred as a result of reviewing unrelated business income tax returns that had been filed by the organizations.

Mr. Rangel. Well, I get the impression, if they do not give you the amount of money that they made, that you will will never know whether there is any unrelated income anyway.

Commissioner Gibbs. I do not think that is correct. If you will take a look at my testimony, you will find that over a third of the returns that are filed, in the most recent year that we have statistics, resulted from our examination efforts, as opposed to voluntary filings by the organizations themselves.

With the audit coverage that we have, we have a pretty good track record in terms of being able to find unrelated business income when we audit the organizations, even if they have not filed an unrelated business income tax return.

Mr. Rangel. But if you collected half of the $57 million just from two cases, would that not give us a target, or an area, where we can see the types of businesses that these tax-exempts are involved in, that gives us the most problem?

So that without identifying the would-be taxpayer, it would at least point your Congress in the right direction as to where you are having the most difficulty, or where taxes should be paid?

Commissioner **GIBBS**. Mr. Rangel, that is a suggestion, as I mentioned, of the General Accounting Office. It is one with which we agree, and that is why we are beginning an indepth analysis, that we have been perfecting this from the standpoint of our computer programs, and our analysis, and we are beginning to do this.

Mr. **RANGEL**. Well, it just seems that your office, under your leadership, is now taking a look at this problem, and you are now putting requests for information on the forms and that is good.

Now, while you are doing that, could Treasury either direct me to your testimony, or suggest what is the policy of the administration as it relates to this very sensitive subject matter, and if it is not in your testimony, could you forward to me what is the administration's policy on unrelated business taxes for tax-exempts. What you think should be legitimately excluded from taxation, areas that you think we should really tax rather than saying that, you know, you do not have enough information.

Could you just put together a statement for me, so that we could use it as a broad outline before we make the political decisions?

Mr. **CHAPOTON**. Mr. Chairman, we have studied this matter very carefully, and I think what we believe is in our testimony. I agree that it is vague in some respects because of the lack of data. I hope that data will be forthcoming. I think that is in part true, though, because of the way this law has built up over so many years, with it generally being recognized that not a great deal of information was being collected.

And perhaps we are at fault there, as well as others, in not seeking more data sooner. But I think as soon as we get more information, which we hope to obtain in part from these hearings, in part from other work we do, in part from additional IRS reporting, we will be able to refine our points, our conclusions.

Mr. **RANGEL**. The refinement is going to be based on where we are losing the money, which you need information for that, but, do you think that your statement outlines the policy that we should have as to who pays taxes and who should not pay taxes, in broad general terms in your statement? I do not see that there at all.

Mr. **CHAPOTON**. We think our testimony outlines the rationale that should be used in making that determination. We think that it is difficult to apply that rationale under present circumstances.

We are going to continue to try to do it, but we would be very hesitant, based on the limited information we have, in trying to be more specific until we know the impact on the people that would be hit by our proposals, many of whom would perhaps not be the ones that we would think should be subjected to additional taxes.

We need to be more specific. We need to have more information, though, to be more specific.

Mr. **RANGEL**. Mr. Gibbs, do you believe churches should file some type of an annual report of the income that they receive?

Commissioner **GIBBS**. From an administrability standpoint, Mr. Rangel, without regard to—I realize there are competing considerations here. Because when you start talking about churches, it is one thing to talk about churches that perhaps, at the present time, are wearing black hats.

There are a number that are wearing white hats. There are established religions in this country, and I gather that you heard from them when section 7611 was passed.

Mr. RANGEL. I am talking about the white-hat churches. Why would you not want them to just file with you how much money they have collected?

Commissioner GIBBS. From the standpoint of the tax administrator, Mr. Rangel, I would not object at all to receiving an annual reporting information return from any of the exempt organizations.

Mr. RANGEL. Now that you do not object, do you think it might make some sense just for them to report how much money they have made, so that we would have some idea as to how much is going into the churches?

Commissioner GIBBS. From the standpoint, again, of being the tax administrator, we would be delighted to have that information. We recognize, however, that there are competing considerations.

Mr. RANGEL. What competes against you knowing how much money churches are collecting?

Commissioner GIBBS. I assume that first amendment issues compete with that. I assume that——

Mr. RANGEL. I did not ask you to tax it. What is competing? The church says it made a million dollars last year.

Commissioner GIBBS. Mr. Rangel, I assume it is the same thing that competed at the time section 7611 was passed.

Mr. RANGEL. What was that?

Commissioner GIBBS. The first amendment issues that are recited in the legislative history to that, as well as the burden that churches have indicated it would impose on them.

Mr. RANGEL. To report how much money they collected.

Commissioner GIBBS. Mr. Rangel, I am simply suggesting to you that it was the legislative history that frames the statute that this Congress passed several years ago.

Mr. RANGEL. Thank you. Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Rangel.

Let me pursue one point that Mr. Rangel had been discussing with respect to the fact that last year we collected almost half of income from two cases, and we have not identified the particular concern.

Now the General Accounting Office tells us that those two cases involved acquisition indebtedness from real estate transactions. Aren't there a lot of other cases just like that out there Mr. Gibbs?

Commissioner GIBBS. Mr. Pickle, I really do not, from the standpoint of the unrelated business income, I do not know.

Chairman PICKLE. Mr. Chapoton?

Mr. CHAPOTON. Mr. Pickle, I think we have no way of really knowing, either. I would think that the audit process would tend to pick up the ones that——

Chairman PICKLE. Well, since the two cases that went to court to actually see whether we would collect the money or not have resulted in one-half the revenue we have collected, then you have to assume that there are a lot of them, perhaps just like that, out there.

But you do not know? Neither one of you knows? All right. Let me go back to you, Mr. Gibbs.

In my statement at the beginning, I observed that there are 850,000 tax-exempt organizations, but only 27,000 reported having unrelated business income. And then I raised the question, are we to assume, then, that 97 percent had no income-producing activities subject to the tax? Is that what we have to assume?

Commissioner GIBBS. Based on the—again, when you say the 850,000, remember, Mr. Chairman, that there were only——

Chairman PICKLE. Well, 27,000 reported that they had income. Now that represents 3 percent, and my question, then, is, does that mean that 97 percent had no income-producing activities that would be subject to the tax?

Commissioner GIBBS. Or for some reason did not pass the thresholds or were otherwise exempted from——

Chairman PICKLE. Yes. Well, I will put it another way: what do we know about the other 97 percent that did not even file?

Commissioner GIBBS. Mr. Chairman, again, let me remind you about how we do our audits in this area. We look at the form 990s which may, or may not, involve a companion form 990-T reflecting unrelated business income. So in terms of actually looking for unrelated business income in organizations that have not reported any, we do that.

I have also indicated in my testimony how we plan to do several things. One, improve the reporting on the form 990s to elicit this information. Two, do a better job in terms of providing information to taxpayers, to exempt organizations who may not be aware of their obligations.

And three—and most particularly—beginning within the next 4 months a taxpayer compliance measurement program to attempt to tell us how much, at the present time, we have in the way of noncompliance in this area.

Chairman PICKLE. I am glad that you are taking the GAO suggestion and improving the selection process by trying to find out who is not paying the tax.

I think the question that constantly comes up to us, that we have to ask ourselves is: are tax-exempt organizations complying with the law? Do you think they are?

Commissioner GIBBS. Based on the information we have, we clearly can find that there are some who are not. I would say the majority of the ones that we are auditing do comply. I would also suggest, Mr. Pickle, as Mr. Chapoton has indicated and I have indicated, given the difficulties of some of the statutory definitions in this area, it is difficult to apply it in a way that everyone would agree would be fair, and I think you are going to hear that in the next 5 days.

Chairman PICKLE. Well, do you know how many organizations did not file 990-Ts? Do you have any idea of how many did not file?

Commissioner GIBBS. I can tell you that with respect to the audit program that we had in 1986, we found that 37 percent of the total 990-T's that we were able to recover, we recovered because we found them rather than the taxpayer filing them.

Chairman Pickle. All right. Then if I understand that statement, of those you did audit, 87 percent of them had not properly complied?

Commissioner Gibbs. That is correct.

Chairman Pickle. And you had to go back and get forms from them?

Commissioner Gibbs. That is correct, but that does not mean that there was tax to be paid. Remember, that the only threshold requirement is that you have more than a thousand dollars of gross income. We found that in a number of instances, Mr. Chairman, because of the way the statutory provisions operate, that a return was filed but no tax was paid, or payable.

Chairman Pickle. Well, we have another panel, and then we have a panel after that, and I am not going to keep asking the questions.

If either one of the other committee members wish to ask further questions, they may certainly be recognized again.

But Mr. Chapoton, I am going to take just a few minutes here to try to review. We have been trying to put down what you are either recommending, or suggesting, are the tough decisions that you want us to make. But let me see if I have you basically summarized here.

With respect to "substantially related", you think our present test is generally satisfactory but it could be improved?

Mr. Chapoton. We think the stated statutory test is generally satisfactory, but it may not be interpreted properly, and if that turns out to be the case, some refinement of it is necessary.

Chairman Pickle. It is not being interpreted properly by the courts?

Mr. Chapoton. By the courts, and perhaps by IRS agents.

Chairman Pickle. All right. Then with respect to the definition of unrelated business income, you said the volunteer, volunteer work for their own convenience is satisfactory, but it should not be unlimited. And that the convenience of the members is a good test, is satisfactory, but it is too broad.

Mr. Chapoton. Well, as regards the question about the convenience of members, we are not sure that ultimately it is a good test. That most of the matters which are being exempted by the convenience test are perhaps exempted by other tests such as the substantially related test, and things of that nature, and therefore, we think the convenience test should be studied, that it might be being abused.

Chairman Pickle. Might be being abused?

Mr. Chapoton. That is correct.

Chairman Pickle. All right. Now with respect to the competition question, and the allocation of expenses, you say that the court cases give too many deductions to reduce the UBI tax.

And you raised the question, should allocation be based on total available time, and that Congress should need to clarify that point?

Mr. Chapoton. That is correct. There is one specific case on the point.

Chairman Pickle. And now you recommend further, that the $1,000 exemption be raised to $5,000?

Mr. Chapoton. To $5,000, yes.

Chairman Pickle. Have you had anybody protesting that recommendation, or is this the first time you have let this be known?

Mr. Chapoton. No. That is the first time we have let that be known, and we just think that based on inflation since that date, and the de minimis concept, that one thousand is too low.

Chairman Pickle. All right. Now with respect to——

Mr. Frenzel. Would you yield, Mr. Chairman, on that.

Chairman Pickle. Yes.

Mr. Frenzel. Isn't $5,000 just as de minimis as $1,000?

Mr. Chapoton. It may well be, Mr. Frenzel. I do not think we need to limit it to that, if there is some indication that it should go higher.

Mr. Frenzel. Thank you.

Chairman Pickle. All right. Let me go on. I have only one or two more observations. With respect to the fragmentation rule, you said that, really, every one should be analyzed as related, or unrelated, but basically, that it is working satisfactorily, as it is now.

Now in the area of unrelated activities handled by for-profit subsidiaries, you say that the definition of controlled subsidiary is inadequate?

Mr. Chapoton. That is correct. The definition of "control" is inadequate.

Chairman Pickle. Yes, and that the definition should be fixed, or clarified?

Mr. Chapoton. Should be clarified, and we think the standard should be broadened to include any more than 50 percent owned subsidiary, or at least consideration should be given to that. Again, we have the same qualifications.

Chairman Pickle. Well you said with respect to the primary purpose test, you need a rule which aggregates activities of exempt subsidiaries, and I do not know that I understand what you mean by that.

Mr. Chapoton. Well, what we mean by that is that right now there is the primary purpose test, that if a tax-exempt entity engages in an unrelated business activity, and if that business activity becomes so large that it becomes the primary purpose of the entity, then the entity loses its tax exemption.

It cannot earn a thousand dollars from its tax-exempt activity, and a million dollars, let's say, from the unrelated business activity. But by dropping that unrelated business activity into a subsidiary it gets around that primary purpose test.

Chairman Pickle. All right. Now in the area of passive income, you said basically it is working satisfactorily, except that a passive income tax should be extended to social welfare organizations, the so-called 501(c)(4)s?

Mr. Chapoton. Well, we think that consideration should be given to looking at it from a pure tax policy standpoint, and not from what is really going on out there. We have to admit that our information is limited, but from a pure tax policy standpoint, the justification for allowing passive income to be tax-exempt seems to us to disappear if the entity uses that income for some noncharitable purpose.

Chairman Pickle. Well, what kind of rule would you have for a labor organization? What is that, 501(c)(5)?

Mr. CHAPOTON. (c)(5) and (6), I believe they are.

Chairman PICKLE. What about labor unions or associations?

Mr. CHAPOTON. Well, it appears that the basis for exempting the passive income of trade associations and labor unions, exempting their passive income from tax, is based more on a flowthrough concept, that the members would get the deduction if they were performing those activities themselves.

If that is the concept, and if the tax policy reason is the sole determining factor of how it is treated, then it raises questions in our mind whether some consideration should be given to saying that exemption is too broad.

Chairman PICKLE. In that area, did you make a recommendation for us, or a suggestion?

Mr. CHAPOTON. No, no. I am sorry, Mr. Chairman. We just recommend that we get the facts, that we look at that on the basis of the facts we are able to obtain, again because we are not entirely sure who it will hit, and how, and what the basic reason, other than tax policy might be, to support that exemption.

Chairman PICKLE. And on royalties, you indicated that the definition was really too broad, and that we may need to exclude amounts measured by net profits?

Mr. CHAPOTON. That is correct. Where royalties are defined by net profits, we think that that might get into being close to a business.

Chairman PICKLE. All right. Well, now, you have made a recommendation in the area of research activities which are generally being pursued in a satisfactory manner, but we need to clarify which type of applied or purely commercial activities should be subject to the tax?

Mr. CHAPOTON. That is right. And the definition of research itself, we inquire whether it is somewhat too broad?

Chairman PICKLE. And in the area of joint ventures and partnerships we need to further clarify, and restrict allocations in those. Well, I say your suggestions, though they are not specific recommendations for statutory changes, are very broad, and very difficult, but I think we must look at them and see if we can do something about them.

So I appreciate the fact that you would even venture this far into making recommendations for it. Before you two gentlemen go, let me ask you one broad question.

Why, in the last 10 years, have the tax-exempt organizations more than doubled? Why is there such a rapid growth in the UBIT exemptions? What has caused this proliferation?

Could you venture a guess why this is developing?

Mr. CHAPOTON. I think that is a very tough question. I think it is one of the questions that has caused the complaints that resulted in these hearings being called, and I not sure that I would want to venture a guess as to why it has grown.

I think obviously, business activity generally has expanded, but the tax-exempt sector perhaps has expanded more. But we are not sure that it is inappropriate, that it is not increasing the functions that these tax-exempt entities are able to perform in furtherance of their primary purpose.

So it may be a very desirable growth, but it does raise questions.

Chairman PICKLE. Mr. Gibbs?

Commissioner GIBBS. Mr. Chairman, I do not know. I suspect there are many reasons, but I do not know what all of those reasons would be.

Chairman PICKLE. And I suspect that both of you have ideas on how it grows and just do not want to say it, but it may well be that our problem is not so much with the tax-exempt organizations that are actually submitting to tests, but the problem may be with those that are actually extending the UBIT and not reporting. They want the income, and for different reasons, they are expanding the UBIT.

But I think that is a question we have got to ask ourselves. Why the great proliferation of this practice? I think that is something that will probably be coming out in the other testimony.

Well, again, I want to say to you that I thank you, we have got a lot of questions and I would like to go into them, but in the interests of time, I think we had better ask the next panel.

I thank you. Any other questions, Mr. Frenzel or Mr. Rangel?

Thank you very much.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Commissioner GIBBS. Thank you, Mr. Chairman.

Chairman PICKLE. Our next panel consists of the testimony from the Honorable Frank Swain, Chief Counsel for Advocacy, the Small Business Administration, and then we will hear from Jennie S. Stathis, Associate Director General of the Government Division of GAO.

Mr. Swain, you may proceed first.

STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Yes, sir, Mr. Chairman.

Thank you very much. I would ask that my statement be received and that I paraphrase the major points of our testimony this afternoon.

I want to congratulate you and the subcommittee for taking on an issue that is very complicated but, nonetheless, extraordinarily important to the small business community. Certainly, as previous witnesses from the Department of Treasury and IRS pointed out, it is a very complex issue, and we appear here as experts on issues relating to the small business community.

Our statement reflects several years of work and concern about this issue, and the many complaints and comments we have heard from the small business community on the issue of competition with tax-exempt organizations.

We would like to point out, and certainly the subcommittee is well aware, because you mentioned it in your various press releases, that last summer, when President Reagan called a White House Conference on Small Business, among the myriad of issues that the small business community could have addressed including international trade, general taxation, labor issues, and regulatory issues, this issue ranked as the third highest priority behind only concerns about the insurance liability and medical benefit situations.

A concern over not-for-profit competition ranked higher than general tax issues and international trade issues, and ranked even higher than concern over SBA programs. I think that the small business community welcomes the attention that this subcommittee is giving their concerns.

My testimony highlights the small business perspective on the nature of the problem, including industries of chief concern, and suggests recommendations for reform of certain tax laws affecting tax-exempt entities.

Our suggestions include a tightening of the current relatedness test, including narrowing or eliminating existing exceptions to the unrelated business income tax; applying an overall cap on the amount of commercial activity which can be conducted by a nonprofit organization, whether related or not; and providing a right of recourse for businesses against unfair competition by tax-exempts in the form of an administrative channel for complaints or an injunctive remedy. In addition, I urge that small business representatives be appointed to the Internal Revenue Service's newly created Exempt Organizations Advisory Group.

Mr. Chairman, there has been much testimony already on facts, figures and statistics on this particular issue. We do have a chart that we have attached to our testimony. We have a larger version here to indicate that, indeed, knowledge about the not-for-profit sector and their commercial activities is sadly lacking.

We do know that there has been a significant expansion in the number of nonprofits, genuine expansion in the impact that they have on the Nation's gross national product and the number of people that they employ both directly and indirectly. And we certainly hear about the significant expansion in related commercial activities and the revenues they generate for tax-exempts. The General Accounting Office will, certainly within a few minutes, have some further specific information on these points.

It seems that often the most important distinction between tax-exempts and for-profits is not in the goods that they sell or the services they provide, the prices charged for these goods or services, or the markets served, but in the taxability of the commercial activities. This is what small businesses think is unfair. Government subsidies, both direct and indirect, provide nonprofits with unfair competitive advantages in areas where for-profits are selling, or would like to sell, the same goods or services.

I would like to briefly outline my perspective, and what we see as the most significant advantages enjoyed by the tax-exempt community. First and foremost, and obviously the primary subject of interest to this subcommittee is the exemption from Federal income taxes. Of course, the previous statements have recited in some detail the history of this exemption but, suffice it to say, that is the single issue which I think characterizes all the small business complaints about not-for-profit commercial activities. Not the fact that the commercial activities are taking place, but that they are taking place under a significantly different set of tax rules and regulations from those applicable to the for-profit community.

A second advantage is the availability of federally subsidized mailing rates for commercial use by tax-exempt organizations. We have some specific description of that in an attachment to our testimony.

Third, tax-exempts gain a significant advantage from numerous State and local exemptions, including exemptions from income sales, business and occupation taxes and property taxes. Now, it may well be said that those, of course, are not the direct province of this subcommittee. However, the fact remains that in most cases, State organizations and State officials grant significant weight to the basic decisions of the Internal Revenue Service over the activities of these organizations when determining State and local exemptions.

Finally, nonprofits gain an intangible advantage in good will from their tax-favored status which enables them to more effectively market commercial goods or services. The public generally confers a higher status to a product bearing the name of a tax-exempt organization, even though identical or similar products are available in the for-profit sector for a similar price.

If you permit me, Mr. Chairman, I would like to address Mr. Frenzel's question of Mr. Chapoton relating to university/college travel services.

One of Mr. Chapoton's responses was that he wasn't really sure whether travel services constituted unfair competition because, in fact, university or college may simply subcontract to a for-profit travel service thus minimizing any advantage of a Federal tax exemption.

Regardless of whether that is true, the university offering such a travel service continues to enjoy the right to advertise the availability of that travel service through mail at not-for-profit rates, continues to enjoy the marketing advantages that the large university institutions would have with mailing lists and so on. And the university or college continues to enjoy a positive reputation for services and merchandise—obviously an advantage that is sometimes difficult, if not impossible, for smaller vendors in that particular area of business to overcome.

The small business community does not want to curtail the many necessary services provided by not-for-profit activities. Tax-exempt organizations are essential when there are unmet needs society desires to be filled and is willing to subsidize through the exemption from Federal income tax. Indeed, the relationship between many nonprofits and for-profits is very close. Small employers donate to and are board members of many charities across the country.

Our point is simply that when tax-exempt become involved in commercial activities to the extent that we feel they have been, it is time for the Congress to take notice of that and reflect on, and I hope reform some of the Federal policies in this area.

Our testimony focuses on two specific industries that appear to generate the most complaints among small businesses: health care and universities. Both of these sectors are significant sectors within the not-for-profit community, and both have seen a significant increase in the amount of revenues they have gained in recent years in commercial or sales activities.

Statistics show that for tax-exempt organizations engaged in health-related services, business, or fee-for-service receipts comprised 56 percent, or $23 billion, of total revenues. Similarly, the business receipts of schools and colleges totaled $6 billion, or 30 percent of overall revenues.

Our chief concern is the prevalence of tax-exempts in the health care field in initiating such commercial activities as paging and answering services, laundry services, retail sales of pharmaceuticals, hearing aids, medical equipment, and so on.

I realize there is a vigorous debate, Mr. Chairman, in the medical community between the for-profit and the not-for-profit hospitals as to various aspects of uncompensated care. I want to make it clear that, as important as that debate is, we come here because of the secondary issues, the proclivity of for-profit and not-for-profit hospitals to conduct numerous activities that we feel are in unfair competition with many small firms.

Most of these activities are not taxed, however, because of their exemption under the UBIT provision which excludes from tax-exempt activities conducted "primarily for the convenience of patients."

Similarly, universities and colleges have generated basically two kinds of complaints: First, complaints about research and testing activities; second, complaints about sales of incidental products and services "for the convenience of students." Of the $125 billion spent in the United States each year for research, 12 percent of this goes to universities, colleges, and not-for-profit scientific organizations. Approximately $8 billion of this goes for basic research, and over $3 billion for applied research. Research by a university, college or hospital is completely exempt from the unrelated business income tax, regardless of whether it is related to any educational or scientific purpose.

We certainly recognize that there is a legitimate need for university-sponsored basic research. Yet, we believe there are many instances where universities are involved in applied research and research with potential commercial application, the revenues of which are tax-free.

Now, what are our recommendations? First of all, we have a series of specific recommendations in our statement that suggest that IRS continue to be the focal point for compiling and reporting statistics on tax-exempts. We believe that the IRS should not only place a priority on analysis of current data, which they already have in-house, but also collect further necessary information in three areas: greater detail on income sources and amounts by source; greater detail on affiliations with other nonprofit and for-profit organizations and, we recommend that the IRS, the Treasury, and the Office of Management and Budget provide revenue estimates on the extent to which the nonprofit sector is subsidized by the tax exemption in the Federal Government's annual budget message.

Extensive testimony over the last couple of hours has examined the details of the difference between the forms 990 and 990-T. We have some specific recommendations for both of those forms. We do believe that form 990 should be modified to separate income into three categories, related, unrelated and exempt under one of the special exceptions. The form 990 should also indicate transfers to and from other nonprofit organizations so that intersector transfers are not double counted.

We believe that the IRS has significant administrative latitude to immediately institute changes in these forms. Obviously, if, after looking at this issue, the subcommittee wishes to either legislate or issue recommendations to the IRS in the form of a subcommittee report, we think that that would be very good news indeed because, obviously, these forms have been slow to evolve over the last several years.

Such guidance from the Congress could include revisions to both the form 990 and form 990–T, and a mandate for the IRS to analyze and report to the Congress such data on a consistent basis.

I do commend the IRS for undertaking a sample study this fall on the form 990–T. But I think, as the previous questions and colloquy pointed out, there is no analogous study plan by the IRS on the form 990 which is filed by many more nonprofits than file a 990–T and contains information on many activities deemed to be related to the tax-exempt's mission yet one commercial in nature and unfairly competes with small business.

What are our specific recommendations for Federal policy changes? First of all, we would agree with Mr. Chapoton that, generally speaking, the relatedness test is a useful test. We do specifically feel, though, that the relatedness test might well be improved by statutory changes of the exact language of that test so that, as was pointed out by Mr. Chapoton, the courts, and perhaps occasionally the IRS will have better and more specific guidance on what types of income are related and unrelated.

The problem really in many cases is that the complaints come not on income that is unrelated, but on income that in fact the IRS or the courts deem as related. We believe, therefore, that narrowing the relateness test is essential.

Our testimony cites several examples and you have a long array of witnesses both today and other days which will clearly give you their own individual experiences on related tax exempt activities that compete with for-profits, so I will skip over the specific examples in our statement.

Second, we believe that code sections 512(b)(7) (8) and (9) involving exceptions from the unrelated business income tax for research should likewise be tightened. The issue of research is a growing one, and it is one in which we see an increasing amount of overlap between the for-profit and the not-for-profit communities. Some of the lines are admittedly difficult to draw, but I think that the Congress should make a good faith effort in redefining this exception.

Third, we believe that the exception of the Internal Revenue Code, section 513(a)(2) which exempts activities conducted for the convenience of members, students, patients, officers, employees, should be considerably tightened or eliminated. As it is difficult to determine whether an activity is related to a tax-exempt mission, so too, is it difficult to define the convenience standard. Over the years the meaning of convenience has been stretched far beyond its original intent. We would suggest that the subcommittee consider repealing the convenience exception in its entirety.

Regardless of the specifics of the unrelated business income tax, we suggest that the subcommittee consider a bright line standard whereby if a not-for-profit entity exceeded a specified level of income generated from commercial activities, the burden of proof would be on the tax-exempt to justify its status.

We have some discussion why we feel that's important in our statement but, basically, it reflects the fact that, regardless of how the relatedness test or the exceptions are characterized, in many cases we will continue to have a very significant amount of commercial income generated by tax-exempts. I think that it is perfectly appropriate for the Government to say that at some point they are going to raise their eyebrows a bit further than they have been consistently in the past and demand a higher standard of proof from the tax-exempt—the taxpayer, or rather nontaxpayer, as the case may be—that their tax-exempt basic purpose is still being adequately fulfilled.

Finally, we recommend that there indeed be recourse for the common person, a small business owner or otherwise, who has a complaint about commercial activities by nonprofits. We recommend not only that the IRS establish a new and strengthened administrative recourse for complaints regarding commercial activities of nonprofits, but that the subcommittee consider enacting a statute which would allow a degree of injunctive relief. Such an injunction could allow a court to have jurisdiction to consider on a case-by-case basis whether a nonprofit is indeed involved in its basic tax-exempt function.

The problem, Mr. Chairman, has been that the for-profit has to wait for the IRS to take some action, or not to take some action. There is no recourse for small employees, except very indirect recourse, through the IRS systems.

Mr. Chairman, I think it's important to mention several points that you will hear in subsequent parts of this hearing. You will hear it said, I am sure, that small businesses are only complaining about this because they don't like any competition. Nothing could be further from the truth. There are 16 million small businesses out there. Competition is a way of daily life with every small business in this country. But competition on the same terms is important when a significant amount of activities fall under a totally different set of laws, and I think that quite appropriately strikes small businesses as unfair.

Second, you may well hear that history is the factor that justifies the granting of certain not-for-profit exemptions even though the times changed.

I think that this subcommittee has to consider on a daily basis how the economy and how tax policy progresses. Despite the fact that there might have been some very legitimate reasons for granting broad tax exemptions several years ago, I think the subcommittee is doing the American electorate a disservice if you consider this argument without acknowledging how the marketplace has changed, how services and technology have changed, and the initiation of new commercial activities conducted by not-for-profits.

Another issue that you may hear about is that if there is a problem with commercial activities engaged in by nonprofits, it is inevitable. Given the changing economy, given the fact that government support is allegedly decreasing, nonprofits assert that they can do nothing else but increase revenues from sales in order to stay going and to fulfill the important needs of society.

That assertion, however, does not mean that when tax-exempts significantly increase their dependence on sales that the subcommittee should ignore the fact that what might have been incidental activity 37 years ago has become very significant activity indeed at this point. The shift in tax-exempt income from contributions and grant sources to business receipts requires a rethinking of tax laws governing this income.

The committee may hear that small business has many advantages and not-for-profits ought to have some advantages of their own. That is the case. Small business does have some advantages although, as you well know, the tax advantages are not currently what they have been in the past. I have heard it said that small businesses enjoy low interest loans. You certainly know that the Small Business Administration doesn't give out any low interest loans any more and hasn't for several years. The fact of the matter is that when the commercial tax-exempt activities take place, then we feel that there are enough advantages under the taxable sector that a nonprofit acting more like a for profit should become a taxable organization.

Finally, you may hear that we don't know enough now so that we can't take any action until we have extensive studies and further information. Mr. Chairman, that may be true for some of the broad solutions. We have attempted to provide the subcommittee with several specific ideas which we feel are appropriate for the subcommittee to act upon without waiting for an extensive 3-inch thick study of the issue.

In short, Mr. Chairman, this is not a labor management issue, this is not a manufacturing versus service economy issue, this is not a Rust Belt versus Sun Belt issue, this is not a young versus old issue. We believe that this is a tax system credibility issue, and we believe that it is appropriate for the subcommittee to not only examine the issue but take action in several areas so that we can avoid what Commissioner Gibbs' mentioned: a growing impression that there has been a piecemeal repeal of the unrelated business income tax.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF

HONORABLE FRANK S. SWAIN

CHIEF COUNSEL FOR ADVOCACY

U.S. SMALL BUSINESS ADMINISTRATION

Mr. Chairman and members of the Ways and Means Subcommittee on Oversight, I am pleased to submit this testimony on the issue of competition between tax-exempt and taxable organizations on behalf of the Office of Advocacy of the U.S. Small Business Administration. Small businesses first brought this issue to our attention over four years ago and we have been deeply involved in the debate since that time. Representatives of other Federal agencies who are here today will have their own perspectives on competition between the tax-exempt and for-profit sectors. This statement represents the views only of the Office of Advocacy and is based on six years of contact with small business owners and considerable work on the issue. We are appearing here in that context. The Treasury Department, as you know, represents the Administration on tax policy matters and the Internal Revenue Service will discuss administrative matters relating to this issue. I wish to stress at the outset that the views expressed herein are only my own and do not necessarily represent the views of the Administration.

I would be happy to share numerous examples of unfair competition communicated to us by small employers, but I believe that several of the witnesses who follow, including the Business Coalition for Fair Competition (BCFC) and many of its members, will provide such information. The BCFC was formed in 1983 in response to small business owners' concerns about competition. The 1986 White House Conference on Small Business also served as a forum for small employers to vent their frustrations and attempt to effect change in this area. That this issue ranked third among all White House Conference recommendations attests to its importance among small businesses nationwide.

Our Office continues to receive calls from small business owners on this issue. There are several local coalitions of former White House delegates who are trying to effect change at the state level; approximately half of all state legislatures have already addressed aspects of the issue. In an annual conference for state legislators to be held in San Antonio this November, the Office of Advocacy will devote considerable attention to competition between tax-exempts and taxable organizations. We are also conducting research which should shed additional light on the extent of competition between tax-exempts and for-profits and describe competitive factors affecting access to capital in both sectors.

My testimony highlights the small business perspective on the nature of the problem, including industries of key concern, and suggests recommendations for reform of certain tax rules affecting tax-exempt entities. These proposals include: (1) a tightening of the current relatedness test, including narrowing or eliminating existing exemptions to the unrelated business income tax (UBIT); (2) applying an overall cap on the amount of commercial activity which can be conducted by a nonprofit organization, whether related or not; and (3) providing a right of recourse for businesses against unfair competition by tax-exempts in the form of an administrative channel for complaints or an injunctive remedy. In addition, I urge that small business representatives be appointed to the Internal Revenue Service's newly created Exempt Organizations Advisory Group.

I would also like to suggest ways to improve the existing collection and reporting of data in order to ascertain the nature and extent of commercial activities conducted in competition with for-profit business. More detailed information is needed on commercial activities, whether they be related or unrelated to their exempt purpose, and on affiliations of tax-exempts with other organizations, both for-profit and nonprofit.

THE EXTENT OF UNFAIR COMPETITION[1]

The transition of our nation from a manufacturing to a service-based economy is reflected in the exponential growth in the service-oriented nonprofit sector, in terms of sheer numbers and economic strength. The number of active nonprofits expanded more than eightfold between 1946 and 1985, from roughly 100,000 to well over 800,000. In the decade between 1968 and 1978 alone, the number of nonprofit organizations almost doubled. Moreover, in 1985 the nonprofit sector accounted for at least 3.3 percent of the gross national product (GNP), up from $1.2 billion and 1.3 percent of GNP in 1930. We estimate that the nonprofit sector currently generates as much as $300 billion in income.

This growth in the nonprofit sector's share of GNP has been coupled with a shift in emphasis from traditional donative sources of funding to other revenue sources. As reported by the General Accounting Office, the tax-exempt community is "increasingly reliant upon income-producing or commercial activities as a source of revenue."[2] While contributions decreased from 17 percent of income to 13 percent between 1946 and 1978, and dues fell from 26 to 12 percent of income in this period, income from "other sources" rose from 57 to 75 percent. Although "other (revenue) sources" cannot be precisely measured, a large portion is business receipts, which includes commercial income. Business receipts grew from around $4.5 million in 1946 to $44.8 million in 1975.

The growth in the nonprofit sector has blurred the separate identities of nonprofit and for-profit entities in many instances. Certain nonprofits that closely resemble for-profits have been established merely to take advantage of the tax-exempt status.[3] Other tax-exempts have expanded their commercial activities into markets dominated by for-profit businesses. Conversely, many for-profits have entered markets once the exclusive domain of nonprofits. The

---

[1] For more detail on the issue see "Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the 1980s," (Third Edition), Office of the Chief Counsel for Advocacy, U.S. Small Business Administration, Washington, D.C. June 1984.

[2] "Tax Policy, Competition Between Taxable Businesses and Tax-Exempt Organizations," U.S. General Accounting Office, Briefing Report to the Joint Committee on Taxation, U.S. Congress, GAO/GGD-87-40BR, February 1987, p. 18.

[3] There is some evidence that the availability of the tax exemption -- at least from state income and sales taxes -- serves as inducement for the formation of tax-exempts in some industries. Henry Hansmann, "The Effect of Tax Exemption and Other Factors on Competition Between Nonprofits and For-Profit Enterprise," University of Pennsylvania, December 1982.

GAO report noted that "while many of these (tax-exempt) activities appear to be traditional charitable-type activities...others appear to be more similar to taxable businesses in nature. For example, some tax-exempt organizations offer publishing services, conduct travel tours, and perform marriage counseling activities."[4]

It seems that often the most important distinction between tax-exempts and for-profits is not in the goods they sell or services they provide, the prices charged for these goods or services, or the markets served, but in the taxability of the activities: this is what small businesses think is unfair. Government subsidies, both direct and indirect, provide nonprofits with unfair competitive advantages in areas where for-profits are selling, or would like to sell, the same good or service.

Competitive Advantages Enjoyed by Nonprofits

A principal advantage realized by nonprofit organizations when competing with for-profit businesses derives from their exemption from Federal income taxes. The first comprehensive Congressional review of the competitive advantage gained by nonprofits through the tax exemption was undertaken by the House Ways and Means Committee approximately 37 years ago. Shortly after those hearings, the 81st Congress enacted the unrelated business income tax (UBIT, I.R.C. sections 511-514) with the intention of eliminating any unfair advantages nonprofits may enjoy under their tax-exempt status. To accomplish this goal, the tax was imposed on the income derived from a regularly conducted trade or business which is not substantially related to the performance of the function(s) upon which the nonprofit's exemption is based. Income substantially related to the exempt function was believed to be an extension of the exempt function performed by the entity and, therefore, left untaxed. Specific activities were expressly excepted from the scope of the tax: including certain research activities (I.R.C. section 512(b)(7), (8), and (9)); activities carried on substantially by volunteers (I.R.C. section 513(a)(1)), conducted primarily for the convenience of members, students, patients, officers, and employees (I.R.C. section 513(a)(2)), or involving the sale of donated merchandise (I.R.C. section 513(a)(3)). Income from passive sources (I.R.C. section 512(b)(1)(2) and (3)) was also excluded.

A second advantage is the availability of Federally subsidized mail rates for commercial use by tax-exempt organizations. By significantly reducing the cost of marketing, nonprofit rates create competitive advantages for the user in direct competition with a small business (see Attachment A for description of other exemptions including the current rates and Postal Rate Commission recommendations for altering nonprofit postal subsidies). Third, tax-exempts gain an advantage from numerous state and local exemptions, including exemptions from income, sales, business and occupation, and property taxes. Fourth, nonprofits are frequently exempted from, or receive special treatment under other Federal and state requirements. These include, Social Security, unemployment insurance, minimum wage, securities, bankruptcy, antitrust, and copyright requirements.

---

[4] *Id*. p. 14.

Finally, nonprofits gain an intangible advantage in goodwill from their tax-favored status which enables them to more effectively market commercial goods or services. The public generally confers a higher status to a product bearing the name of a tax-exempt organization, even though identical or similar products are available in the for-profit sector for a similar price. This so-called "halo" effect carries over into more concrete advantages, such as public service announcements and other free advertisements that are used to market a commercial service or product stamped with the imprimatur of a tax-exempt's name.

The small business community does not want to curtail the many necessary services provided by nonprofits. Tax-exempt organizations are essential when there are unmet needs society desires to be filled and is willing to subsidize through the exemption from Federal income tax. Many nonprofits sustain and boost the quality of life in their communities and, in fact, make them attractive for small businesses and their customers. Indeed, the relationship between many nonprofits and for-profits is symbiotic. Small employers donate to and are board members of many charities across the country.

Although, small business' criticisms of unfair competition has created considerable concern in the nonprofit sector, particularly among many of the social service organizations, the bulk of complaints we hear relate to other than the social or human service tax-exempts. Small employers thrive with competition, but they do object when their competitors are operating under a different set of rules.

INDUSTRY FOCUS OF PROBLEM

The problem of unfair competition encompasses many industries, yet is particularly acute in two areas: health care and universities.

The most significant volume of small business complaints are directed at the surge in commercial activities engaged in by hospitals and higher education institutions, which together account for almost 70 percent of the nonprofit sector. Relative to other tax-exempt organizations, both of these sectors rely heavily on business receipts.[5] Statistics show that for tax-exempt organizations engaged in health-related services, business or fee-for-service receipts comprised 56 percent, or $23 billion, of total revenue. (With the exception of mutual organizations, health-related services had the highest percentage of business receipts as a percent of total revenue.) Similarly, the business receipts of schools and colleges totaled $6 billion, or 30 percent of overall revenue. The current data does not allow one to be more specific about the portion of business receipts that are related or unrelated.

With respect to the health field, I realize that there is a heated debate underway among for-profit and nonprofit health providers regarding the justification for granting tax-exempt status to hospitals. In 1985, approximately 81 percent of all non-governmental hospitals were nonprofits. Small employers are not so concerned about this debate, although its outcome may have ramifications for unfairness in ancillary commercial activities conducted by tax-exempts. Of chief concern is the prevalence of tax-exempts initiating such commercial activities as paging, answering, and laundry services, and sales of retail pharmaceuticals, hearing aids, medical equipment, and prosthetics. These services are readily available from for-profit businesses who pay Federal, state, and local taxes and full postal rates. It appears inequitable not to tax a nonprofit organization which provides the same good or service to the same market. Many of these activities are not taxed, however, because of their exemption under the UBIT provision which does not tax activities conducted "primarily for the convenience of patients". This exception has been stretched far beyond its original meaning, providing an overly large umbrella for many hospital activities. For example, a hospital's operation of a gift shop, patronized by patients and visitors making purchases for patients, was considered to fall within the exception, as was a hospital's operation of a cafeteria and coffee shop. Additionally, the sale of hearing aids by a hospital was found to be tax-exempt, as was the operation of a parking lot.

---

[5] "Tax Policy, Competition Between Taxable Businesses and Tax-Exempt Organizations," Appendix IV. (Business receipt statistics for health-related services and schools and colleges are from Appendix IV.)

Many nonprofit hospitals have developed for-profit enterprises ranging from restaurants to real estate.

> The diverse, nontraditional businesses which community hospitals have engaged in through affiliates include commercial cleaning, interior decorating, computerized billing for doctors, catering, health and fitness clubs, travel agencies, marketing of frozen foods for the elderly, data processing, day-care centers, and medical hotels for patients who no longer need hospital care but are not ready to return home.[6]

Little is known about these ventures, but a considerable number of questions have been raised as to the appropriateness of such diversification among nonprofit health providers. Some commentators believe that the unfair competition can be resolved by forcing tax-exempts to separate their commercial activities by forming for-profit subsidiaries. However, this may be no solution. Even if a nonprofit health provider were to establish a for-profit subsidiary, tax-free seed funds can be accumulated to support the enterprise, the nonprofit's charitable name can be used for marketing purposes, and items of income and expense can be allocated between the for-profit and nonprofit for more favorable tax treatment.

Universities and colleges have generated complaints in two general areas, research and testing activities and sales of incidental products and services "for the convenience of students." Of the $125 billion spent in the U.S. for research and development 12 percent or $11 billion goes to universities, colleges, and nonprofit scientific organizations. Approximately $8 billion of this goes for basic research and over $3 billion for applied research.[7] Research by a university, college, or hospital is completely exempt from the UBIT, regardless of whether it is related to any educational or scientific purpose (I.R.C. section 512(b)(8)). It is generally recognized that there is a legitimate need for university-sponsored basic research, yet there are many instances where universities are involved in applied research and research with potential commercial application. For example, in Nevada, one state university has underbid a small business and won several marketing and opinion polling contracts; a University of Pittsburgh professor earned $60,000 a month by testing households for radon; and at a New Orleans university the laboratory conducted asbestos analysis for industry.

---

[6] James J. McGovern, "Restructured Nonprofit Hospitals," Tax Notes, April 27, 1987, p. 406.

The ad hoc approach for applying the "primarily for the convenience of students" exception has drawn confusing distinctions. For example, watches sold by a college bookstore are taxable, while refrigerators and computers are not. As in the case of the convenience for patients exception, the exception for students has been broadened beyond original intent. For example, the operation of a ski facility as part of a physical education program was found to be an exempt activity under this exception, as were the operations of vending machines and laundromat facilities.

DOCUMENTATION OF COMMERCIAL ACTIVITIES CONDUCTED BY NONPROFITS

The one aspect out of the panoply of issues in contention upon which there is agreement among all parties is the lack of specific data on the tax-related activities of nonprofit entities.

We suggest that the IRS continue to be the focal point for compiling and reporting statistics on tax-exempts. The IRS should not only place a priority on analysis of current data, but also collect further necessary information. Additional information on tax-exempts is needed in three areas: (1) greater detail on income sources and amounts by source; (2) affiliations with other nonprofit and for-profit organizations; and (3) revenue estimates on the extent to which the nonprofit sector is subsidized by the tax exemption. Each of these additional data requirements will be addressed in turn.

The attached chart (Attachment B) reveals what nonprofit data are presently collected, whether it is consistently analyzed, and where new data are needed. Most of the data are from two IRS returns, Form 990, which is used to measure nonprofit revenues and expenses, and Form 990-T, which measures the amount of unrelated business income generated by tax-exempts. All tax-exempts with annual income in excess of $25,000 are required to file IRS Form 990. Unfortunately, data from the 990 Forms are not regularly analyzed by the IRS, and the Forms are inadequately designed to gauge the extent of competition or commercial activity.

All program revenues are grouped together and reported in Line 2, Part I, and Lines (b)-(g) in Part IV of the 990 Form (Attachment C). The Form should be modified to separate income into these three categories; related, unrelated, and exempt under a special exception. The Form should also specify the amount of income generated by each program revenue source. Many small employers contend that certain nonprofit related activities should be taxed. We must know the individual sources of related activities and how much revenue they supply. Finally, the Form 990 should indicate transfers to and from other nonprofit organizations, so that intra-sector transfers are not double counted.

---

[7] Science and Technology Data Book (NSF 86-311), Washington, D.C., 1986.

Question 78(c) of Form 990 does request an organization with gross sales or receipts from business activities not reported on Form 990-T to attach a statement explaining why the income is not reported on Form 990-T. Apparently, the design and intent of question 78(c) is to separate related income (i.e., not taxable) and explain the reasons for it being related (e.g., the income falls under the research exemption). The question is framed, however, so that business activities are not delineated, but reported together. Additionally, the various reasons for not reporting different sources of business income on Form 990-T are not necessarily identified.

The key to examining the extent of competition is to require the filer to specify various sources of business receipts, the amount generated from each source, whether it is related or unrelated income, and if it is related, indicate why it qualifies as such. Even Form 990-T does not provide information that ties each source of unrelated income to the amount it generates. (Tax-exempts with unrelated business gross income in excess of $1,000 must file Form 990-T.) There is only space for three unrelated business activity codes at the top of the Form (B) and reporting lines for unrelated trade or business gross income and gross receipts or sales (Lines 1 and Part I, 1a.) (Attachment D).

The details of changes in the Forms 990 and 990-T may be worked out in the Internal Revenue Service's newly formed Exempt Organizations Advisory Group. I strongly urge that small business representatives, knowledgeable in accounting, be appointed to this Group in order to provide valuable insight on the perspective of small business. As it stands now, only representatives of nonprofit organizations are on the Advisory Group.

In order to measure the type and magnitude of commercial activities in the nonprofit sector it would be simpler to modify and build upon existing income returns rather than create an entirely new mechanism. This approach would not only be more cost-effective, it would minimize the paperwork burdens on the Service and tax-exempt organizations. I realize that to date the Internal Revenue Service's mandate has not included collecting such information. Congressional guidance in this area can result in better data on the competition issue. Such guidance should involve revisions to both the Forms 990 and 990-T as described above, and a mandate for the IRS to analyze and report these data on a consistent basis. I commend the IRS for undertaking a sample study this fall on the Form 990-T in conjunction with their TCMP program, but I ask that additional analysis begin on the form 990 as well.

Likewise, I commend the Subcommittee for recommending additional reporting requirements for tax-exempt organizations, particularly with regard to their affiliations with other tax-exempt organizations.[8] I would suggest, however, that the reporting requirements be broadened to encompass affiliations or relationships with for-profit businesses. Shared resources, interlocking directorates, and the exchange of funds or assets among for-profits and nonprofits can provide some tax-exempts and their related for-profit ventures with unfair advantages.

Finally, I suggest that revenue estimates for the nonprofit sector be accounted for by the Federal Government in the same manner as other tax subsidies. The Congressional Budget Act of 1974 (Public Law 93-344) requires a listing of tax expenditures in the annual Budget analysis. The "tax expenditures" are defined to include "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a defense of liability." Included as "taxpaying units" subject to the expenditure analysis are "...corporations where activities and ownership meet the requirements of Section 501..."[9] Special Analysis G of the Budget analysis currently details tax expenditures for such items as preservation of historic structures, exclusion of employer contributions for medical insurance premiums, but does not include the subsidy provided to tax-exempt organizations.

SUGGESTIONS FOR FEDERAL POLICY CHANGES

The Subcommittee has asked that we propose solutions to the problems addressed by these hearings. I am submitting some suggestions that fall within three broad areas: a narrowing of the scope of income related to a nonprofit's purpose, a cap on all commercial activity, and the creation of an administrative remedy. The latter suggestion is necessary to assure taxpaying entities that the law, however crafted, is being strictly enforced.

The substantially related test has failed to provide a workable standard for determining when an activity should be taxable. One of the principal problems with the test is that it fails to capture the many commercial activities that compete with small business. An overriding purpose of the tax exemption for revenues generated by activities related to the purpose of an exempt organization is to promote the organization's efforts for the general welfare. In particular, the exemption is to encourage the provision of goods and services which are not found in the private sector, or are distinguishable for other reasons, such as quality. That similar commercial activities are conducted by the nonprofit and for-profit sectors, calls into question the rationale for granting tax exemptions to commercial activities. The expansion of for-profit firms in markets formerly dominated by nonprofits, and of tax-exempts in for-profit markets, has caused considerable overlap of goods and services in the 37 years since the enactment of the UBIT.

---

[8] Attachments to letter from the Honorable J.J. Pickle, Chairman, Subcommittee on Oversight, Committee on Ways and Means, to the Honorable Dan Rostenkowski, Chairman, Committee on Ways and Means, June 8, 1987.

[9] Special Analysis, The Budget of the United States Government, Fiscal Year 1987, Special Analysis G.

Another important problem is that the boundaries between related and unrelated activities are so unclearly drawn that the test has proven difficult for the Service to administer and enforce. Hair-splitting court cases, such as Hi-Plains Hospital v. United States, illustrate that "substantially related" requires subjective decisionmaking.[10] That fewer than 3 percent of tax-exempts filing Form 990 also filed Form 990-T, during a time when business receipts exempt from tax reached an all time high, strongly indicates that either (a) unrelated income is not being reported, or (b) much of what is commercial income is liberally categorized as related. Other Federal representatives can better discuss rulings and enforcement problems they have encountered with this law.

The substantially related test allows ample room for nonprofits to take up a wide range of activities which are somewhat related to their mission, yet are commercial in nature and compete with for-profit firms. Even when an activity is considered unrelated and, therefore, taxable, the exempt organization gains a significant advantage because it is able to use untaxed income from other sources, such as dues, contributions of related activity, to fund unrelated commercial activity. This is similar to advantages received by for-profit subsidiaries of nonprofit organizations.

Given these problems with the current substantially related test, it seems that the most logical solution would simply be to tax those activities which compete with the for-profit sector. Formulation of an overall test for taxability of income or for qualification of exempt status based upon the existence of competition, however, may be as difficult as determining if those activities are related. Therefore, I suggest retaining the UBIT but more narrowly defining substantially related activities and its exceptions. I also advocate placing a limit on the overall commercial income which can be received tax free.

(1) Redefining Relatedness

Section 513(a) defines the term "unrelated trade or business" as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organizations of its charitable, educational or other purpose or function constituting the basis for its exemption..." This definition has been subject to 37 years of judicial opinion, and its application to specific facts has yielded widely differing results. To cite just a few examples, the operation of a miniature golf course by an exempt organization whose purpose is to provide for the welfare of young people has been held to constitute unrelated trade or business income, while the operation of a beauty shop by a senior citizens' center has been found to be a substantially related activity. Accounting and tax services furnished to certain members of a labor organization were found not to be substantially related, while the provision of legal services by a Chamber of Commerce in reviewing and certifying export documents was substantially related.

---

[10] See "Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the 1980s," p. 29-30.

During this period the definition of substantially related business income has also been broadened to include commercial activities not presented to Congress during its original deliberations. It has been held to encompass the sale of broadcasting rights, the operation of grocery stores, and horse racing tracks, the exchange of mailing lists, and the sale of milled lumber and greeting cards, to name just a few activities.

It is now time for this Committee to reexamine the substantially related test with the benefit of the lessons learned over the past 37 years. In order to ensure that competitive commercial activities of nonprofit organizations are properly taxed, the unrelated business income tax should be retained, but the standard for determining which activities are taxable should be tightened. This can be accomplished by expressly defining what is meant by "substantially related" activities in Section 513 of the Code.

Such a definition might state, for example, that "business income will only be related, and therefore exempt, if the activity generating the income is so fundamental to the existence of the exempt purpose as to be a mere extension of it, capable of standing alone to fulfill the exempt purposes of the organization."

Redefining research

Code sections 512(b)(7),(8), and (9), respectively, provide exceptions from the unrelated business income tax for research performed; (1) for the United States, any state, or any political subdivision thereof, (2) performed by colleges, universities, or hospitals, or (3) performed by entities operated primarily for purposes of carrying on fundamental research the results of which are freely available for the public.

Ideally, the research exemption should be confined to basic research, i.e., research that furthers knowledge of the subject under study, rather than its practical application, under such definitional guidelines as provided by the Code of Federal Regulations and OMB Circular A-11. This would grant an exemption for research which is not as likely to be provided by, and compete with, the private sector.[11] It would be difficult, however, to hinge the taxability of an activity on the nebulous distinction between basic and applied. Instead, two other options may serve to mitigate most of the unfair competition created by the research exception under UBIT.

First, the research exemption could be modified to exclude research fees generated by testing services offered to the public, unless a tax-exempt is required to do so by state law. Routine testing provided to the public for a fee is essentially commercial in nature and is not designed to further knowledge of the subject under study. A second alternative would be to include as taxable income research funds from contracts which require the results to belong to the research sponsor. Income from research projects in which the results were freely available to the public would remain tax-exempt, while research performed under a contract or institutional policy that would delay publication of the results or require the copyright or patent to be transferred to the research sponsor would be taxable. This approach would ensure that research which is subject to tax would most likely have practical application or the potential for practical application.

---

[11] 48 CFR 31.205-18(a) Federal Acquisition Regulations; OMB Circular A-11, section 44.3., p. 98, May 28, 1986.

Eliminating "convenience" exceptions

Under I.R.C. section 513(a)(2) the term 'unrelated trade or business' expressly excepts a trade or business conducted primarily for the convenience of members, students, patients, officers, or employees. The problems with this exception are similar to the problems experienced with the substantially related test. There is great difficulty in determining which activities fall within the exception, and many activities which fall within the exception nonetheless compete with for-profits. I suggest that the Subcommittee consider repealing the "convenience" exception in its entirety.

Income derived from activities formerly falling under the exception would remain untaxed if they are substantially related to the tax-exempts' function and if the ceiling on all commercial activity described below is not exceeded. Activities which fall outside the exemption or exceed the ceiling could still be conducted, but they would be subject to tax in the same manner as a similar activity conducted by a for-profit.

(2) Imposition for Ceiling on Commercial Income

In order to ensure that levels of commercial income, whether related or unrelated, are not excessive, I believe that a ceiling on income from a tax-exempt's regularly conducted commercial activities should be imposed. When the ceiling is exceeded, the organization should be presumed to be operating as a for-profit business and, unless proven otherwise, denied its tax-exempt status. Income from commercial activities should include remuneration received for goods and services in an amount significantly greater than the costs of producing the goods or rendering the service, determined under generally accepted accounting principles. It should also include income generated from the sale of goods or services similar to goods or services provided by for-profit businesses in an established market, when the cost to the consumer of the similar goods or services provided by the tax-exempt approximates the fair market value of the goods or services provided by the for-profit sector.

I realize that the chief task related to this proposal is where to draw the bright line on the level of overall commercial activity permitted. The diversity of the nonprofit sector leads one to conclude that the permissible levels of commercial income should be established on an industry-specific basis. We believe that it is necessary to analyze current tax-exempt income sources and revenues generated, by industry and organization size in order to make this determination. The data suggestions described above would provide answers to these questions and could be used for determining at what point commercial income should be limited.

(3) Taxpayer recourse for unfair competition

In the course of these hearings, your Subcommittee will hear descriptions of many localized incidents of unfair competition. For small business, which suffers from unfair competition, the hearings represent the first Congressional attention received in the past twenty years. Despite the very real cases recorded in their testimony, there is no means by which they can individually assert their complaints against the tax-exempt organizations. The unrelated business income tax, in the rare cases it serves to address the problem of unfair competition, is a very blunt tool.

Small business, on whose behalf the unrelated business income tax was legislated, should be given the opportunity to voice their complaints against the particular tax-exempt entity engaged in unfair competition against them. To this end, I suggest that the Subcommittee examine two possible options: the development of a channel for administrative recourse and the creation of an injunctive remedy.

Small business could greatly benefit from the establishment of a special administrative channel within the Internal Revenue Service for receiving complaints against tax-exempt unfair competition. The IRS could better target their compliance efforts by knowing those activities which are commercial in nature and in competition with goods and services provided by the private sector. As the General Accounting Office noted in a 1985 letter to the I.R.S.:

> Because IRS data shows increasing UBI activity high estimates of tax loss due to UBI nonreporting, and low yield from most of IRS' current UBI examinations, IRS may want to focus more on UBI organizations with a high potential for being noncompliant in addition to assuring that exempt organizations are operating in accordance with their exempt purposes.[12]

Accordingly, I believe that a channel for complaints of unfair competition should be established at the IRS, and a mechanism developed to fairly and efficiently examine the merits of the complaints in terms of the compliance of the nonprofit with the unrelated business income tax. At the very least this procedure should involve the creation of a specific complaint form, the appropriate dissemination of that form, and the effective review of the complaint by an IRS panel to determine if a preliminary investigation or audit is warranted. In order for the review to be effective, it should require the IRS to respond to the business complaint within a specified time, such as 30 days.

---

[12] Johnny C. Finch, Senior Associate Director, U.S. General Accounting Office, letter to Mr. S. Allen Winborne, Assistant Commissioner for Employee Plans and Exempt Organizations, Internal Revenue Service, Washington, D.C., July 8, 1985.

The details of such an administrative mechanism would require further work, but I believe the function is an important one. Essentially, it would accomplish three objectives: (1) it will increase the efficiency of enforcement mechanisms by alerting the IRS to especially abusive activities; (2) it will serve as a clearinghouse of the complaints advanced against nonprofits in order to determine the nature of the activities that are the subject of legitimate complaint; and, (3) it will enable the IRS to prioritize auditing of activities most likely to be in violation of the underlying purpose of the UBIT.

Perhaps the most effective instrument for alleviating unfair competition would be to grant an equitable private right of action to for-profits against tax-exempt firms. This remedy might involve the filing of a complaint for injunctive relief by the for-profit against the tax-exempt entity which sets forth evidence of improper competition. A satisfactory showing of competition by the for-profit should shift the burden to the tax exempt to demonstrate, at a minimum, that its commercial activities are either unrelated and subject to tax, or related and exempt. The court hearing the complaint should have the authority to suspend or limit the commercial activities of the tax exempt entity if the tax-exempt organization has not satisfactorily demonstrated that it is properly characterizing its commercial activities as unrelated or otherwise complying with the law.

CONCLUSION

Mr. Chairman, over the next week and a half you will be hearing from many small employers on this issue. I have worked with many of them over the past four years, as well as met numerous times with nonprofit representatives, academics, and government officials. My perception is that the intensity of this problem is only likely to sharpen over time, particularly in light of recent restrictions on nonprofit income sources other than business receipts.

The small business community supports the independent sector, but is opposed to the variety of commercial services conducted by tax-exempts that have little relevance to social goals and create tremendous income streams. The issue is not of revenue, but of fairness to small business.

I firmly believe that there is a problem with the way the present tax laws are structured and hope that we can look toward reform. My suggestions for changes in Federal policy point in a direction towards which we should be moving. In addition, we need to revise and place a priority on analyzing applications for tax-exempt status and annual reporting forms, 990 and 990-T. This will provide the data so urgently needed to measure the sources and magnitude of competition between taxable and tax-exempt organizations.

I will be happy to address any questions from members of the Subcommittee. Thank you.

ATTACHMENT A
OTHER EXEMPTIONS

I. Postal Rate Exemptions

Currently, there are no restrictions on the amount of advertising content which can be contained in nonprofit third-class postage, and regardless of the amount of advertising content the rate of postage is not affected. In particular, the third class rate for nonprofit mail presorted to the carrier is 5.5 cents as opposed to 8.3 cents for a for-profit. Business mail presorted to five zip codes is available at a cost of 7.1 cents to nonprofits and 10.1 cents to for-profit businesses, and the difference in cost for all other bulk third-class mail is 12.5 cents for for-profits and 8.5 cents for nonprofits.

The special nonprofit second-class postal rates are increased if advertising content exceeds 10 percent, but the increase in the rate is less than the increase required for business second-class postage. In a study conducted by the U.S. Postal Rate Commission pursuant to the Budget Reconciliation Act of 1985, 45 percent of nonprofit second class mail was found to contain more than 10 percent advertising content. Of the nonprofit third-class mail, 28 percent was found to contain advertising.

The total revenue foregone through subsidized postage is projected by the Rate Commission to be $462 million in 1989. Of this subsidy, an estimated $53 million is accounted for by nonprofit second-class postage and $367 million by nonprofit third-class postage. For 1987, $650 million is revenue is estimated to be foregone by the subsidies, and in 1988 it is estimated to be $556 million. The amount of the subsidy provided for favored nonprofit mail reflects`the exclusion from costs for overhead and other administrative expenses not directly allocable to that mail. Some of this subsidy is offset by direct appropriations by Congress and some of it is offset by the increased rates paid by for-profit businesses. Under a new method of accounting for this subsidy recently adopted by Congress, the so-called equal-markup method, the appropriations for the postal subsidies will decrease, causing a corresponding increase in the business rate. If the Postal Service is not permitted to adjust its nonprofit postal rates, and the appropriations are phased-out, the for-profit mailers will be required to assume all costs previously covered by the appropriation.

The Postal Rate Commission made recommendations relative to both 2nd and 3rd class postage. With respect to second-class postage, the Commission recommended that the subsidy be continued for the editorial portion of publication only, and that the advertising portion pay the regular rates. Adoption of this recommendation would have the effect of equalizing advertising rates of nonprofit and commercial second class publications. Additionally the Commission recommended retaining the current rule which allows up to 10 percent advertising content without increasing those rates.

For third-class mail, the Commission recommended that the eligibility initially depend on whether the advertising concerns products, services, gift premiums, or travel and entertainment. If the item advertised is a product, service or gift premium the Commission recommended applying a test based upon the principles of the unrelated business income test. The Commission would tighten the restrictions by requiring the advertised product to be actually manufactured or the service provided by members or beneficiaries of the organization in order to receive preferred treatment. Similarly, in the case of services the Commission recommends that any involvement by an ineligible person would disqualify the mailing for preferred rate purposes. For example, a nonprofit could not solicit its members to sign up for a certain credit card using subsidized mailing, since the credit card company is a necessary joint producer of the service. The Commission further recommends treating gift premiums consistent with the manner in which those items have been treated under case law arising under the unrelated business income tax. Accordingly, premiums that are offered in return for contributions approximating the value of the premium are not to be given favored treatment. Further, all promotion of insurance and travel would be denied preferred rates.

II. Exemptions from FICA and FUTA

A. Social Security

Within the Social Security Act, specific trust funds are created from which insurance benefits are to be paid. Section 401 establishes the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund. Funding is provided by various taxes which are enumerated. [42 USC § 401]. One such tax provision establishes the rate of payment as a percentage of wages paid by the employer. [26 USC § 3111]. A definition of employment is, therefore, important.

The definition of "employment" as defined in § 410 is complex. For purposes of the Social Security Act, services which are performed in the employ of a church or church-controlled organization which has elected treatment under 26 USC § 3121 (w) are excluded from the definition of "employment." This exclusion, however, does not include services performed in an unrelated trade or business. [42 USC § 410 (a) (8) (B)]. Under § 3121 (w) any church or church-controlled organization may elect to be excluded from employment for purposes of 42 USC § 401 only if the organization is opposed for religious reasons to the payment of the tax imposed by 26 USC § 3111.

Another exemption excludes the employment of students by schools or student organizations. Domestic service performed by an enrolled student, in a local college pub or local chapter of a college fraternity or sorority, who is regularly attending classes at a school, college, or university is excluded from the definition. [42 USC § 410 (a) (2)]. Moreover, service performed for a school, college, or university by a student enrolled and regularly attending classes is also excluded. [42 USC § 410 (a) (10)].

B. Unemployment Insurance

The Federal Unemployment Tax Act imposes an excise tax on all employers. This tax, which is based on a percentage of the total wages paid to employees, provides funding for Federal unemployment benefits. [26 USC § 3301].

As under the Social Security Act, the term employment includes a list of exceptions, including one for service performed in the employ of a religious, charitable, educational, or other 501 (c) (3) organizations. [26 USC § 3306 (c) (8)].

Another exception excludes domestic service in a private home, local college club, or local chapter of a college fraternity or sorority, so long as the quarterly cash remuneration does not exceed $1000. [26 USC § 3306 (c) (2)]. An exception is also provided for services to a tax-exempt organization if the cash remuneration is less than $50. Finally, services provided to a school by a student, or employment outside the school for which credit is given, are also exempt. [26 USC § 3306 (c) (10)].

The term "wages" includes all remuneration except payments made to or on behalf of an employee or his beneficiary from certain tax-exempt trusts. This exception applies only if the payment is made to the employee as a beneficiary and not for services rendered. 26 USC § 3306 (b) (5) (A)].

III. Exemptions From Economic and Trade Regulations

A. Price Discrimination

The Robinson-Patman Anti-discrimination Act prohibits discriminatory practices between different purchasers in terms of price, services, or facilities. [15 USC § 13 (a)]. Two years after this prohibition was enacted, an exception was passed by Congress with the intended purpose of permitting nonprofit institutions to operate as inexpensively as possible. Specifically, § 13c states that nothing in the Anti-discrimination Act applies to purchases of supplies for their own use by schools, colleges, universities, public libraries, churches, hospitals, and charitable institutions not operated for profit. [15 USC § 13c].

The word "purchases" in the Act has been construed liberally to include the party selling to the nonprofit institution. [Logan Lanes, Inc. v. Brunswick Corp., 378 F.2d 212, (1967)]. Furthermore, the word "supplies" has been held to include anything required to meet the needs of the nonprofit institution. [Logan Lanes, Inc.] The net result of this exemption is that a seller may engage in price discrimination when selling to a nonprofit institution.

B. Unfair Competition

The Federal Trade Commission (F.T.C.) was established in 1914 under 15 U.S.C. § 41 to prevent unfair or deceptive acts affecting commerce. [15 USC § 45 (a) (1)]. The FTC was empowered to prevent persons, partnerships, and corporations from engaging in such unlawful conduct. [15 USC § 45 (a) (2)]. Under the Act, the term "corporation" is defined to include a company, trust, or association organized to carry-on business for profit. [15 USC § 44].

To the extent the term "corporation" is defined in terms of profit, nonprofit organizations are thereby excluded from the jurisdiction of the FTC. This exclusion, however, has its limitations. The above definition has been interpreted so as to provide a shield for truly eleemosynary institutions and not as a blanket exclusion of nonprofits. [Community Blood Bank, Inc. v. FTC, 405 F2d 1011 (1969)]. While protection of nonprofits is considered legitimate in terms of protection from unwarranted governmental intrusion, the nonprofit corporate veil can be pierced when necessary to protect the public interest. [Ohio Christian College, FTC Dkt. 8820, CCH Trade Reg. Rep 20017, (1972)].

C. Securities

In 1933, Congress passed the "Securities Act of 1933" [15 U.S.C. § 77a] to protect the public from fraud and abuse associated with blue sky schemes. To achieve this goal, the Act replaced the prevailing philosophy of caveat emptor with one of full disclosure; the rationale being that full disclosure leads to informed decisionmaking. Specifically, this legislation imposes various reporting requirements on the issuance of securities. [15 USC § 77a et. seq].

Certain securities listed in § 77c of the Act are specifically exempted from these reporting requirements. Securities which are issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit are among those exempted. However, the organization must not be organized or operated in a manner inconsistent with the terms of the exemption.

III. Miscellaneous Provisions

A. Copyright

The owner of a copyright is granted the exclusive right to reproduce the copyrighted work, prepare derivative works based on it, distribute copies of it to the public, perform it, and display it [17 USC § 106], subject to numerous exceptions. The exceptions are presented in terms of situations which are not infringements of copyright. For example, the use of copyrighted material during face-to-face teaching activities by nonprofit teaching institutions is not an infringement. Other exceptions include: secondary transmissions of primary transmissions, made by a nonprofit organization which is not a cable system, without commercial advantage and without charge [17 USC § 111(a)(4)]; nonprofit educational institutions are allowed to make 30 copies of copyrighted material provided no copies are made from these copies and all but one copy is destroyed within one year [17 USC § 112 (b)]; and reproduction of copyrighted material is allowed by a public broadcasting agency which engages in the activity with a nonprofit institution [17 USC § 118 (d) (3)].

B. Bankruptcy

Nonprofit organizations get special treatment under Federal bankruptcy provisions. Section 303 (a) specifies the conditions under which an involuntary case may be commenced. Such a case may be commenced only under chapter 7 or chapter 11, and only against a person who may be a debtor under these chapters. (The Chapter 7 provisions apply to individuals and provide for the liquidation of assets, while the chapter 11 provisions apply primarily to corporations and provide for the reorganization of the business.) Specifically excluded is an organization which is not a "moneyed business, or commercial" corporation [11 USC § 303(a)].

Courts which have interpreted the phrase "moneyed business, or commercial" limit the meaning to corporations which are organized for profit. [In Re Allen University, 497 F.2.d 346 (CA4 S.C.) (1974)]. Furthermore, the courts have declared that charitable and benevolent associations, not operated for profit, are not subject to involuntary bankruptcy proceedings. [In Re Michigan Sanitarium & Benevolent Association, 20 F. Supp 979 (D.C. Mich) (1937)]. Thus, creditors cannot force nonprofit debtors into bankruptcy proceedings.

ATTACHMENT B

NONPROFIT DATA

Year	Minimum Gross Income Level for Required Reporting	Number of Tax-Exempts		Number of Tax-Exempts 501(c)(3)	Total Income (millions)	Total Revenues or Income As Percent of GNP
		All	Filed 990; 990-T			
1968	$ 5,000	409,789[15]		137,487[15]		
1973	5,000	430,769[1]		95,760[1]		
1974	5,000				$ 62,000[6]	2.8[12] 5.1[6]
1975	5,000		179,000[2] 325,777[15]		115,000[2] 65,000[9] 68,807[15]	7.4[2] 4.2[3]
1976	10,000		11,000[4]			
1977	10,000				176,500[15] 89,000[6]	
1978	10,000	806,375[15]	216,000[2]	293,974[15]	238,000[2]	11.0[2]
1979	10.000	824,536[5]				
1980	10,000	846,433[5] 785,000[6]	304,000[2]		270,000[2] 123,000[6]	10.3[2] 5.5[6]
1981	10,000	777,000[1]	319,000[1]			
1982	25,000		75,738[8]	264,890[8]	234,000[15] 196,000[8]	6.3[3]
1983	25,000	751,818[7] 780,000[14]	328,000[2] 173,000[9&13] 23,000[4]	201,000[13] 306,000[14]	314,000[2] 115,000[10] 162,000[13]	9.5[2] 3.5[12]
1984	25,000	871,000[5]				
1985	25,000	854,806[15] 887,000[5] 850,000[11]		366,071[15]	300,000[11]	

Year	BEA's Nonprofit Institution's Sector as a Percent of GNP[10]	Nonprofit Payroll As Percent of Total Payroll	UBI Reported (990-T)		UBI Unreported (990-T)		Commercial Activity as Percent of Nonprofit Total Income	Unrelated Commercial Activity as Percent of Nonprofit Total Income
			All	501(c)(3)	All	501(c)(3)		
1973	2.8			$ 5m[1]	$34m[1]	$17m[1]	Data Not Available	Data Not Available
1974	2.9							
1975	3.0							
1976	2.9							
1977	2.8							
1978	2.8							
1979	2.9							
1980	3.0	6.7[6]						
1981	3.1				16m[4]			
1982	3.3		$24m[2]		15m[7]	9[7]		
1983	3.4	6.3[3]			10m[7]	3[7]		
1984	3.3		50m[13]					
1985	3.3							

Footnotes

[1] IRS "Income Tax Compliance Research," from 1973-1981, July 1983.

[2] SBA, April 1985 Current Topic: "Statistical Profile of the Nonprofit Sector" [1980, 1981 and 1983 data includes some tax exempts not required to file; percent of GNP represents total revenues of nonprofits].

[3] IRS, Statistics of Income Division [figures represent "charitable organizations"].

[4] GAO, July 8, 1985 memo, pg. 2 [figures are from IRS statistics and represent only 990-T reporting].

[5] IRS master file, exempt organizations.

[6] Independent Sector, "Dimensions of the Independent Sector," p. 1 (percent of GNP is total income of nonprofits and includes estimated volunteer time).

[7] GAO, March 29, 1985 memo, enclosures II, V. [Unreported UBI are from a sample audit of total returns (approximately 3 percent].

[8] Laura M. Heuchan, "Nonprofit Charitable Organizations 1982."

[9] Harrison Wellford, attorney for Family Service America, May 15, 1986, letter to Small Business Administration.

[10] Bureau of Economic Analysis, Department of Commerce, Survey of Current Business Data (includes firms providing only services to individuals).

[11] Ways and Means press release, September 1986.

[12] Statement of Professor Henry Hansmann, before the Symposium on Nonprofits' Competition with Small Business July 27, 1983. Figures are based on data published in the National Income Accounts by the U.S. Department of Commerce.

[13] John Sullivan, IRS Statistics of Income Division, Discussion of the Small Business Administration Report "Statistical Profile of the Nonprofit Sector," August 1985, (Total income estimate is from charitable organizations and is based on a sample].

[14] Statement of Mr. Gerald Sack, Exempt Organizations Division, IRS, before the Symposium on Nonprofits Competition with Small Business, July 27, 1983.

[15] Tax Policy, Competition Between Taxable Businesses and Tax-Exempt Organizations," U.S. General Accounting Office, Briefing Report to the Joint Committee on Taxation, U.S. Congress, GAO/GGD-87-40BR, February 1987. Total income is for 501(c)(3) organizations.

ATTACHMENT C

Form **990**

Department of the Treasury
Internal Revenue Service

Return of Organization Exempt From Income Tax

Under section 501(c) (except black lung benefit trust or private foundation) of the Internal Revenue Code or section 4947(a)(1) trust

Note: You may be required to use a copy of this return to satisfy state reporting requirements. See instruction D

OMB No. 1545-0047

1986

For the calendar year 1986, or fiscal year beginning , 1986, and ending , 19

Use IRS label. Otherwise, please print or type.	Name of organization	**A Employer identification number** (see instruction L)
	Address (number and street)	**B State registration number** (see instruction D)
	City or town, state, and ZIP code	C Section 4947(a)(1) trusts filing this form in lieu of Form 1041, check here ▶ ☐ (see instruction C10)

D Check type of organization—Exempt under section ▶ ☐ 501(c) ( ) (insert number), OR ▶ ☐ section 4947(a)(1) trust

E Accounting method: ☐ Cash ☐ Accrual ☐ Other (specify) ▶

Check here if application for exemption is pending ▶ ☐

F Is this a group return (see instruction J) filed for affiliates? . . . . . ☐ Yes ☐ No
If "Yes," enter the number of affiliates for which this return is filed ____
Is this a separate return filed by a group affiliate? . . . . ☐ Yes ☐ No

G If "Yes" to either, give four-digit group exemption number (GEN) ▶

H ☐ Check here if your gross receipts are normally not more than $25,000 (see instruction B11). You do not have to file a completed return with IRS but should file a return without financial data if you were mailed a Form 990 Package (see instruction A). Some states may require a completed return.

I ☐ Check here if gross receipts are normally more than $25,000 and line 12 is $25,000 or less. Complete Parts I (except lines 13-15), III, IV, VI, and VII and only the indicated items in Parts II and V (see instruction I). If line 12 is more than $25,000, complete the entire return.

501(c)(3) organizations and 4947(a)(1) trusts must also complete and attach Schedule A (Form 990). (See instructions.)

Part I Statement of Support, Revenue, and Expenses and Changes in Fund Balances

					(A) Total	These columns are optional—see instructions (B) Unrestricted/ Expendable	(C) Restricted/ Nonexpendable
Support and Revenue	1	Contributions, gifts, grants, and similar amounts received:					
	a	Direct public support					
	b	Indirect public support					
	c	Government grants					
	d	Total (add lines 1a through 1c) (attach schedule—see instructions)					
	2	Program service revenue (from Part IV, line f)					
	3	Membership dues and assessments					
	4	Interest on savings and temporary cash investments					
	5	Dividends and interest from securities					
	6a	Gross rents					
	b	Minus: rental expenses					
	c	Net rental income (loss)					
	7	Other investment income (Describe ▶)					
			Securities	Other			
	8a	Gross amount from sale of assets other than inventory					
	b	Minus: cost or other basis and sales expenses					
	c	Gain (loss) (attach schedule)					
	9	Special fundraising events and activities (attach schedule—see instructions):					
	a	Gross revenue (not including $______ of contributions reported on line 1a)					
	b	Minus: direct expenses					
	c	Net income (line 9a minus line 9b)					
	10a	Gross sales minus returns and allowances					
	b	Minus: cost of goods sold (attach schedule)					
	c	Gross profit (loss)					
	11	Other revenue (from Part IV, line g)					
	12	Total revenue (add lines 1d, 2, 3, 4, 5, 6c, 7, 8c, 9c, 10c, and 11)					
Expenses	13	Program services (from line 44, column (B)) (see instructions)					
	14	Management and general (from line 44, column (C)) (see instructions)					
	15	Fundraising (from line 44, column (D)) (see instructions)					
	16	Payments to affiliates (attach schedule—see instructions)					
	17	Total expenses (add lines 16 and 44, column (A))					
Fund Balances	18	Excess (deficit) for the year (subtract line 17 from line 12)					
	19	Fund balances or net worth at beginning of year (from line 74, column (A))					
	20	Other changes in fund balances or net worth (attach explanation)					
	21	Fund balances or net worth at end of year (add lines 18, 19, and 20)					

Part II **Statement of Functional Expenses**

All organizations must complete column (A). Columns (B), (C), and (D) are required for most sections 501(c)(3) and (c)(4) organizations and 4947(a)(1) trusts but optional for others. (See instructions.)

Do not include amounts reported on lines 6b, 8b, 9b, 10b, or 16 of Part I.	(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
Expenses 22 Grants and allocations (attach schedule)			▨	▨
23 Specific assistance to individuals			▨	▨
24 Benefits paid to or for members				
25 Compensation of officers, directors, etc.				
26 Other salaries and wages				
27 Pension plan contributions				
28 Other employee benefits				
29 Payroll taxes				
30 Professional fundraising fees		▨	▨	
31 Accounting fees				
32 Legal fees				
33 Supplies				
34 Telephone				
35 Postage and shipping				
36 Occupancy				
37 Equipment rental and maintenance				
38 Printing and publications				
39 Travel				
40 Conferences, conventions, and meetings				
41 Interest				
42 Depreciation, depletion, etc. (attach schedule)				
43 Other expenses (itemize): a				
b				
c				
d				
e				
f				
44 Total functional expenses (add lines 22 through 43) Organizations completing columns B-D, carry these totals to lines 13-15.				

Part III **Statement of Program Services Rendered**

List each program service title on lines a through d; for each, identify the service output(s) or product(s), and report the quantity provided. Enter the total expenses attributable to each program service and the amount of grants and allocations included in that total. (See instructions for Part III.)	Expenses (Optional for some organizations—see instructions)
a (Grants and allocations $)	
b (Grants and allocations $)	
c (Grants and allocations $)	
d (Grants and allocations $)	
e Other program service activities (attach schedule) (Grants and allocations $)	
f Total (add lines a through e) (should equal line 44, column (B))	

Form 990 (1986) Page 3

Part IV **Program Service Revenue and Other Revenue (State Nature)**	Program service revenue	Other revenue
a Fees from government agencies		
b		
c		
d		
e		
f Total program service revenue (enter here and on line 2)		▨
g Total other revenue (enter here and on line 11)		

Part V **Balance Sheets** *If line 12 or Column (B) of line 59 is more than $25,000, complete the entire balance sheet. If line 12, Part I, and Column (B) of line 59 are $25,000 or less, you may complete only lines 59, 66, 74, and 75.* **See instructions.**

Note: **Columns (C) and (D) are optional.** *Columns (A) and (B) must be completed to the extent applicable. Where required, attached schedules should be for end-of-year amounts only.*	(A) Beginning of year	End of year		
		(B) Total	(C) Unrestricted/ Expendable	(D) Restricted/ Nonexpendable
Assets				
45 Cash—non-interest bearing				
46 Savings and temporary cash investments				
47 Accounts receivable ▶ ______				
minus allowance for doubtful accounts ▶ ______				
48 Pledges receivable ▶ ______				
minus allowance for doubtful accounts ▶ ______				
49 Grants receivable				
50 Receivables due from officers, directors, trustees, and key employees (attach schedule)				
51 Other notes and loans receivable ▶ ______				
minus allowance for doubtful accounts ▶ ______				
52 Inventories for sale or use				
53 Prepaid expenses and deferred charges				
54 Investments—securities (attach schedule)				
55 Investments—land, buildings and equipment: basis ▶ ______				
minus accumulated depreciation ▶ ______ (attach schedule)				
56 Investments—other (attach schedule)				
57 Land, buildings and equipment: basis ▶ ______				
minus accumulated depreciation ▶ ______ (attach schedule)				
58 Other assets ▶ ______				
59 Total assets (add lines 45 through 58)				
Liabilities				
60 Accounts payable and accrued expenses				
61 Grants payable				
62 Support and revenue designated for future periods (attach schedule)				
63 Loans from officers, directors, trustees, and key employees (attach schedule)				
64 Mortgages and other notes payable (attach schedule)				
65 Other liabilities ▶ ______				
66 Total liabilities (add lines 60 through 65)				
Fund Balances or Net Worth				
Organizations that use fund accounting, check here ▶ ☐ and complete lines 67 through 70 and lines 74 and 75.				
67a Current unrestricted fund				
b Current restricted fund				
68 Land, buildings and equipment fund				
69 Endowment fund				
70 Other funds (Describe ▶ ______)				
Organizations that do not use fund accounting, check here ▶ ☐ and complete lines 71 through 75.				
71 Capital stock or trust principal				
72 Paid-in or capital surplus				
73 Retained earnings or accumulated income				
74 Total fund balances or net worth (see instructions)				
75 Total liabilities and fund balances (net worth) (see instructions)				

Form 990 (1986) Page 4

Part VI **List of Officers, Directors, and Trustees (List each officer, director, and trustee whether compensated or not.) (See instructions.)**

(A) Name and address	(B) Title and average hours per week devoted to position	(C) Compensation (if any)	(D) Contributions to employee benefit plans	(E) Expense account and other allowances

Part VII **Other Information** Yes No

76 Has the organization engaged in any activities not previously reported to the Internal Revenue Service?
If "Yes," attach a detailed description of the activities.

77 Have any changes been made in the organizing or governing documents, but not reported to IRS?
If "Yes," attach a conformed copy of the changes.

78 a Did the organization have unrelated business gross income of $1,000 or more during the year covered by this return?

b If "Yes," have you filed a tax return on Form 990-T, Exempt Organization Business Income Tax Return, for this year?

→ ⓒ If the organization has gross sales or receipts from business activities not reported on Form 990-T, attach a statement explaining your reason for not reporting them on Form 990-T.

79 Was there a liquidation, dissolution, termination, or substantial contraction during the year? (See instructions.)
If "Yes," attach a statement as described in the instructions.

80 Is the organization related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization? (See instructions.)
If "Yes," enter the name of the organization ▶ .... and check whether it is ☐ exempt OR ☐ nonexempt.

81 a Enter amount of political expenditures, direct or indirect, as described in the instructions

b Did you file Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations, for this year?

82 Did your organization receive donated services or the use of materials, equipment, or facilities at no charge or at substantially less than fair rental value?
If "Yes," you may indicate the value of these items here. Do not include this amount as support in Part I or as an expense in Part II. See instructions for reporting in Part III ▶

83 *Section 501(c)(5) or (6) organizations.*—Did the organization spend any amounts in attempts to influence public opinion about legislative matters or referendums? (See instructions and Regulations section 1.162-20(c).)
If "Yes," enter the total amount spent for this purpose

84 *Section 501(c)(7) organizations.*—Enter amount of:

a Initiation fees and capital contributions included on line 12

b Gross receipts, included in line 12, for public use of club facilities (see instructions)

c Does the club's governing instrument or any written policy statement provide for discrimination against any person because of race, color, or religion? (See instructions.)

85 *Section 501(c)(12) organizations.*—Enter amount of:

a Gross income received from members or shareholders

b Gross income received from other sources (do not net amounts due or paid to other sources against amounts due or received from them)

86 *Public interest law firms.*—Attach information described in the instructions.

87 List the states with which a copy of this return is filed ▶ ....

88 During this tax year did you maintain any part of your accounting/tax records on a computerized system?

89 The books are in care of ▶ .... Telephone no. ▶ ....
Located at ▶

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge.

▶ Signature of officer Date ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ Date Check if self-employed ▶ ☐

Firm's name (or yours, if self-employed) ▶ ZIP code

ATTACHMENT D

Form **990-T**
Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return

(Under Section 511 of the Internal Revenue Code) For calendar year 1986 or other tax year beginning ...., 1986, and ending ...., 19 .....

OMB No. 1545-0687

1986

Name of organization

Address (number and street)

City or town, state, and ZIP code

A Employer identification number (employees' trust see instruction for Block A)

B Enter unrelated business activity codes from page 12 of instructions

C Check box if address changed . . . . ▶ ☐

D Exempt under section . . . . . . ▶ 501 ( ) ( )

E Check type of organization . . ▶ ☐ Corporation ☐ Trust ☐ Section 401(a) trust

F Group exemption number (see instructions for Block F) ▶

If the unrelated trade or business gross income is $10,000 or less, complete only page 1 and Part III on page 2, and sign the return. Complete all applicable parts of the form (except lines 1 through 4) if unrelated trade or business gross income is over $10,000.

Taxable Income

1 Unrelated trade or business gross income (state sources ▶ ....) . . . . | 1

2 Deductions (including net operating loss) (complete Parts I and II instead of lines 1, 2, 3, and 4 if you have gross income over $10,000) . . . . | 2

3 Unrelated business taxable income before specific deduction (subtract line 2 from line 1) . . . . | 3

4 Specific deduction (see instructions) . . . . | 4

5 Unrelated business taxable income (subtract line 4 from line 3 or enter amount from line 33, page 2. If line 4 is greater than line 3, enter the lesser of zero or line 3.) . . . . | 5

Tax Computation

Organizations Taxable as Corporations (See Instructions for Tax Computation)

6a Check if you are a member of a controlled group (see sections 1561 and 1563) . . . . . . ☐

b If checked, see instructions and enter your share of the $25,000 in each taxable income bracket:
(i) $ .... (ii) $ .... (iii) $ .... (iv) $ ....

c If checked and your tax year includes July 1, 1987, enter share of tax bracket amounts:
(i) $ .... (ii) $ ....

7 Income tax on amount on line 5, above. Check here ▶ ☐ if alternative tax is used . . . . . | 7

Trusts Taxable at Trust Rates (See Instructions for Tax Computation)

8 Enter the tax from the tax rate schedule in the instructions on the amount on line 5 . . . . . . | 8

Total Income Tax

9a Foreign tax credit (corporations attach Form 1118, trusts attach Form 1116) | 9a

b Other credits (see instructions) . . . . | 9b

c General business credit.—Check if from ☐ Form 3800 ; ☐ Form 3468 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586 | 9c

10 Total (add lines 9a through 9c) . . . . | 10

11 Subtract line 10 from line 7 or line 8 . . . . | 11

12 Tax from recomputing prior year investment credit (attach Form 4255) . . . . | 12

13 Minimum tax on tax preference items (Corporations only—see instructions) . . . . | 13

14 Alternative minimum tax (Trusts only—see instructions) . . . . | 14

15 Total tax (add lines 11 through 14) . . . . | 15

16 Credits and payments:

a Tax deposited with Form 7004 or Form 2758 . . . . | 16a

b Foreign organizations—Tax paid or withheld at the source (see instructions) . | 16b

c Credit from regulated investment companies (attach Form 2439) . | 16c

d Credit for Federal tax on gasoline and special fuels (attach Form 4136) . | 16d

e Other credits and payments (see instructions) . . . . | 16e

17 Total credits and payments (add lines 16a through 16e) . . . . | 17

18 **TAX DUE** (subtract line 17 from line 15) See instructions for depositary method of payment . . ▶ | 18

19 **OVERPAYMENT** (subtract line 15 from line 17) . . . . ▶ | 19

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer | Date | ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security no.

Firm's name (or yours, if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Part I Unrelated Trade or Business Income

1a	Gross receipts or sales .... b Less returns and allowances .... Balance ▶	1c		
2	Cost of goods sold and/or operations (Schedule A)	2		
3	Gross profit (subtract line 2 from line 1c)	3		
4a	Capital gain net income (attach separate Schedule D) (see instructions)	4a		
b	Net gain or (loss) from Part II, Form 4797 (attached)	4b		
c	Capital loss deduction for trusts	4c		
5	Income or (loss) from partnerships (attach statement)	5		
6	Rent income (Schedule C)	6		
7	Unrelated debt-financed income (Schedule E, line 2)	7		
8	Investment income of a section 501(c)(7), (9), (17) or (20) organization (Schedule F)	8		
9	Interest, annuities, royalties, and rents from controlled organizations (Schedule G)	9		
10	Exploited exempt activity income (Schedule H)	10		
11	Advertising income (Schedule I, Part III, Column A)	11		
12	Other income (see instructions for line 12—attach schedule)	12		
13	TOTAL—Unrelated trade or business income (add lines 3 through 12)	13		

Part II Deductions Not Taken Elsewhere
(Except for contributions, deductions must be directly connected with the unrelated business income.)

14	Compensation of officers, directors, and trustees (Schedule J)	14		
15	Salaries and wages	15		
16	Repairs (see instructions)	16		
17	Bad debts (see instructions)	17		
18	Interest (attach schedule)	18		
19	Taxes	19		
20	Contributions (see instructions)	20		
21	Depreciation (attach Form 4562) 21			
22	Less depreciation claimed in Schedule A and elsewhere on return 22a	22b		
23	Depletion	23		
24a	Contributions to deferred compensation plans (see instructions)	24a		
b	Employee benefit programs (see instructions)	24b		
25	Other deductions (attach schedule)	25		
26	TOTAL DEDUCTIONS (add lines 14 through 25)	26		
27	Unrelated business taxable income before allowable advertising loss (subtract line 26 from line 13)	27		
28	Advertising loss (Schedule I, Part III, Column B)	28		
29	Unrelated business taxable income before net operating loss deduction (subtract line 28 from line 27)	29		
30	Net operating loss deduction (see instructions)	30		
31	Unrelated business taxable income before specific deduction (subtract line 30 from line 29)	31		
32	Specific deduction (see instructions for line 4 of page 1)	32		
33	Unrelated business taxable income (subtract line 32 from line 31. If line 32 is greater than line 31, enter the lesser of zero or line 31.) Enter here and on page 1, line 5	33		

SCHEDULE A—COST OF GOODS SOLD AND/OR OPERATIONS
(See Instructions for Part I, line 2)

Method of inventory valuation (specify) ▶

1	Inventory at beginning of year	1		
2	Purchases	2		
3	Cost of labor	3		
4	Other costs (attach schedule)	4		
5	TOTAL—Add lines 1 through 4	5		
6	Inventory at end of year	6		
7	Cost of goods sold and/or operations. Subtract line 6 from line 5. (Enter here and on line 2, Part I.)	7		

Part III Statements Regarding Certain Activities and Other Information

		Yes	No
1	At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account) (see page 9 of the instructions for exceptions and filing requirements for TD F 90-22.1)?		
	If "Yes," write in the name of the foreign country ▶		
2	Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you had any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926.		

The books are in care of ▶ Telephone number ▶

Mr. **Rangel** [presiding]. Thank you, Mr. Swain.

You have some pretty forceful recommendations for this committee, and throughout your testimony you referred to "what we believe is necessary."

Who are "we" in your testimony?

Mr. **Swain**. Well, the testimony is obviously a product of my office, Mr. Chairman. But my opinion on it has been formed over 5 years as the Chief Counsel for Advocacy at the Small Business Administration handling innumerable complaints about this topic, attending more than 30 conferences to which several thousand business owners came to over the last several years to talk about the various priorities of small business. This is a key priority for the small business community.

Mr. **Rangel**. So this is the basis of your experience and discussions with staff and coming together to put together this very useful testimony.

Mr. **Swain**. Yes, Mr. Rangel.

Mr. **Rangel**. And you are giving this to me on behalf of the Small Business Administration?

Mr. **Swain**. Yes, sir.

Mr. **Rangel**. The reason I ask is because you went out of your way in your opening remarks to say that these are your views and not necessarily the views of the administration.

Why such an overt disclaimer when I am trying to find out what the views are of the administration?

Mr. **Swain**. Well, I think that obviously the views of the administration on tax policy are predominantly within the purview of the Department of Treasury and represented by Deputy Assistant Secretary Chapoton this morning. And to the extent that our views are more specific or more intense on certain issues than his, I think that we feel very sincerely about the correctness of our views but, understandably, just because we differ somewhat on some of the specifics with Deputy Assistant Secretary Chapoton, we wanted to provide the committee our opinion as well.

Mr. **Rangel**. Well, as a result of receiving these complaints from small businesses around the country, have you been able to target or to focus as to what areas you think are the most flagrant abuses of groups that should be paying taxes that are not paying taxes?

Mr. **Swain**. As a result of the complaints that we have heard, Mr. Rangel, we have identified the two specific areas of educational institutions and universities on the one hand, and not-for-profit health care providers on the other hand. We have specific recommendations that we feel would resolve many of the problems that we have been hearing about.

The lion's share of the complaints that we have been receiving have not involved the typical charitable social service agency for which fund raising by commercial sales is occasional or contributes insignificantly to total revenues.

Mr. **Rangel**. Well, could you provide to the committee a very brief summary of where your complaints are targeted so that we would not just use a broad brush in looking at this reform but, rather, try to get at those problems that represent a great loss of revenue and where they most adversely affect small businesses.

Mr. **Swain**. Well, yes, sir. I should say that we come here as no experts on the revenue loss implications. I have no idea, and we have never even looked at where there might be a potential loss of revenue. Our concern is the volume of complaints that we have been receiving from small businesses.

Mr. **Rangel**. Okay.

Mr. Frenzel.

Mr. **Frenzel**. Thank you, Mr. Chairman.

I would like to thank Mr. Swain for his testimony. I think it is exceedingly helpful to us, and we do want to be responsive.

I would raise a little question here in that some of the things that the people you represent are complaining about are items beyond the jurisdiction of this committee. We do not control mail subsidies, and we don't have anything to do with wage and hour laws and certain exemptions from them or from fringe benefits. Some of those are controlled in the States; some by other departments of Government, where other committees of jurisdiction have sway.

We understand the problem and it is important that you bring it to us so we can see the whole picture. But we just want to be sure that you understand that our ability to act here is pretty much limited to the UBIT, and that in those other areas you are going to have to proceed independently.

Mr. **Swain**. I certainly understand that, Mr. Chairman, and I included mention of those factors in our testimony to attempt to explain to you the intense interest that this issue has within the small business community. Because occasionally it is said that even if certain not-for-profit tax-free activities were made taxable, that it still wouldn't matter very much.

But, in fact, the basic decision by the Internal Revenue Service to categorize an organization as not-for-profit for taxation purposes triggers an array of sometimes directly related, sometimes indirectly related, other advantages in Federal and State laws. And that's why the small business community is so concerned about it.

Mr. **Frenzel**. You made some suggestions about who should be on the Commissioner's advisory panel, and I think those are good ones, and I hope you will process them directly to the IRS, and I am sure that members of the committee will probably want to do the same.

You have also suggested that the IRS or somebody have a special complaint bureau. My opinion is because of things we have talked about, that's perhaps not the right agency and that you probably are, because you are going to have to filter the complaints that relate to things that are way beyond the IRS' jurisdiction, and be able to screen out those things that are within their jurisdiction. Because the people for whom you are an advocate are not going to be able to distinguish that very easily other than without very careful guidance from yourself. So I don't think it's a bad idea, but it seems to me to be almost beyond the competence of the IRS.

Would you comment, please, on that?

Mr. **Swain**. Well, I would guess, Mr. Frenzel, that we have in effect been a complaint bureau for the past several years on this issue, particularly given the fact that in 1983 we published a report of a meeting that we held on this issue. I might even say that our office has been somewhat of a lightning rod on this issue over the past few years.

We certainly continue to process any complaint and refer them in appropriate circumstances to the IRS. We have a nationwide toll free number, which is available to receive any complaint on this or any other matters of Federal policy.

My point in the statement was really that when there is a complaint of this activity, the person complaining, number one, has no direct right of action against the not-for-profit that is allegedly abusing the system. And, number two, as I think Commissioner Gibbs' testimony clearly demonstrated, whether the IRS takes action as a result of any complaints is strictly a private matter between the IRS and the not-for-profit entity. So, there is really no sense of access or satisfaction within the small business community at all as to how these issues are raised. And indeed this committee is doing a great service in holding these hearings on this particular issue.

Mr. **Frenzel**. Thank you.

May I inquire further if you believe that a certain class of taxpayers should be allowed to sue someone under the tax law to collect?

Mr. **Swain**. No, sir. That is not what we are proposing.

Mr. **Frenzel**. Can you go into that a little more?

Mr. **Swain**. We are not suggesting that taxpayers in effect have a private right of action to collect taxes. But we are suggesting that taxpayers have a private right of action to question the continued fairness of a tax exemption. It may well be that having raised that question to a court, the court may make a ruling based on the facts of an individual case that a not-for-profit organization has gone beyond its original charter, therefore, its tax exemption is jeopardized.

At that point, it obviously becomes a matter between the IRS and any organization as to what the consequences of that ruling would be.

Mr. **Frenzel**. Okay. I guess I'm a little more clear.

You would be questioning the determination of the IRS, that it was carrying out the intent of the law correctly?

Mr. **Swain**. Yes, sir.

Mr. **Frenzel**. And to say the ultimate private right of action is to get rid of the people up here so they write better laws.

Mr. **Swain**. I might add, Mr. Frenzel, that I believe there are some analogous statutes in the environmental field where a citizen need not wait for the Justice Department or the EPA to proceed on a particular complaint about an environmental hazard, but can bring a case to the court's attention on his own.

Mr. **Frenzel**. Well, I thank you for your testimony and hope that we can make some progress.

Chairman **Pickle**. Mr. Swain, you stated that at a recent White House conference facts showed a good number of the small businesses, almost a third of them or in excess of a third of them, complained about unfair competition that they have experienced in this general field with tax-exempt organizations.

Mr. **Swain**. Yes, sir.

Chairman **Pickle**. Do you have any proof, or conclusive proof, that the nonprofits have caused damage to these small business firms?

Mr. **Swain**. In a statistical sense, Mr. Chairman, no. I think our chart indicates that statistically one can prove very little about any aspect of this issue. One of our recommendations is that the IRS follow up with some additional statistical analysis to depict what we feel is a very significant problem.

I certainly, in a year of going around to small business conferences and listening to some very heartfelt and specific complaints, have a deep feeling for and understanding of this issue.

But that is clearly a qualitative impression on my part. We don't have the evidence yet to make it quantitative.

Chairman **Pickle**. Well, did you submit to our committee examples, in your testimony, of the unfair competition between profits and nonprofits where businesses have been hurt, or is it just a statement you are making?

Mr. **Swain**. Yes, sir. First of all, in 1983, when we published an initial report, we itemized several examples there. The committee has that. We mentioned some other examples in our testimony today, and I would be happy to submit further, in effect, case studies or examples on any particular industries.

Chairman **Pickle**. I'm trying to see the scope of it, the depth of it, the volume of it, and the type of businesses that have been adversely affected. We may hear this from other witnesses as we go along. I'm sure we will.

But, from your standpoint, I hear you saying that they complained it's unfair competition. I would like to see specifically what has been unfair and how it adversely affected them.

Mr. **Swain**. Yes, sir.

Chairman **Pickle**. I would like you to submit that. For instance, do you know of any business, for-profit or nonprofit, which cut their prices in a manner and in an amount that did damage to the for-profit business in competition with them?

Mr. **Swain**. I believe that you will hear several examples of that from your witnesses in succeeding days of the hearings.

We certainly have some specific examples. A typical case, for instance, may have involved a procurement for, let's say, an environmental impact statement, where people bidding on the environmental impact statement may be local engineers as well as the engineering department of a local university. Because of overhead advantages, because of student worker rates and other advantages, it may well be that the bid submitted by the not-for-profit may simply be 1 or 2 or 3 percent less than the bid submitted by the for-profit but, nonetheless, that's enough to tip the award into the nonprofit's favor.

We have several of those sorts of example, Mr. Pickle, and I would be happy to submit them to the committee. I have a book with several examples here, and I could give you some more right now if you'd like.

Chairman **Pickle**. Well, you don't need to do that now, but I would like to have them for the record because I want to see graphically what businesses have been hurt. I don't question your statement. I just would like to see specific examples of how it occurred.

[The information was not received.]

Chairman PICKLE. Can we change a lot of our difficulties by establishing strong reporting procedures on the 990 and the 990-T? Did you give us specific suggestions how we could do that?

Mr. SWAIN. Yes, sir. We are giving you in that statement very specific suggestions. And I would like to reemphasize that I believe that changes in the 990 and the 990-T can be accomplished administratively by the IRS. In most cases, those questions are not determined by statute.

Chairman PICKLE. Have you ever asked the IRS to change those?

Mr. SWAIN. We have had a series of meetings at the staff level with the IRS back and forth over the last several months. But our statement this afternoon, Mr. Chairman, is our first specific itemization of where we are recommending changes to the IRS.

Chairman PICKLE. Well, I'm glad that you are talking to them, and I'm glad they are taking under advisement specific recommendations that you have made?

Mr. SWAIN. I believe so, sir, and that is why we were very pleased when the IRS recently eliminated its former form 990 Advisory Committee and, in effect, substituted a broader Exempt Organizations Advisory Committee.

Our point is that we hope that there are some representatives of the business community on that committee.

Chairman PICKLE. Do you have the support of Treasury in the recommendations you're making?

Mr. SWAIN. I would say that it's clear, Mr. Chairman, that we are going much further and much more specific in our recommendations than the Treasury Department is prepared to go at this point. But they certainly never told me not to come up here and not to say any of this.

Chairman PICKLE. Well, does Treasury know what your recommendations are?

Mr. SWAIN. Oh, yes, sir.

Chairman PICKLE. Today?

Mr. SWAIN. Yes. We've had a series of discussions——

Chairman PICKLE. It seemed to me in passing that you and Treasury ought to be of one general accord in making your recommendation, or if there is a difference, we ought to have that pointed out. I would think that you all would be working together to try to reach some kind of accommodation. But you operate separately.

Mr. SWAIN. Well, I think it's fair to say, Mr. Chairman, that I would not disagree with any of the recommendations that Mr. Chapoton made in his statement to the committee.

Based on our experience, not in tax policy, but based on our experience in small business, we would urge a greater urgency, and we are prepared to go further than the Treasury Department is apparently willing to go at this point in terms of recommending that you actually take action on these issues as opposed to simply studying them. It's a matter of degree.

Chairman PICKLE. Well, we may have other questions submitted to you directly, but I certainly thank you for your testimony.

Mr. SWAIN. Thank you, Mr. Chairman.

Chairman PICKLE. We will now hear from Jennie Stathis, Associate Director, U.S. General Accounting Office, and we welcome your testimony and recommendations.

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. STATHIS. Thank you. We are pleased to be here today to assist in your inquiry into the income-producing activities of tax-exempt organizations and the unrelated business income tax. I will submit my statement for the record, but because it does include some of the same things you have already heard this afternoon, I will summarize.

Chairman PICKLE. Without objection, the full statement will appear in the record.

Ms. STATHIS. We are making three major points in it. First, that the available data indicate that tax exempts are increasingly reliant on income-producing or commercial activities to generate revenue. However, there are no complete data to quantify the nature and extent of tax-exempt organizations' involvement in these activities and most of the data that are available, are old. Consequently, it is difficult to determine if these activities are resulting in widespread competition between the taxable business and tax-exempt communities. The second part of our statement deals with the congressional passing of the unrelated business income tax that is imposed on commercial activities not substantially related to a tax-exempt organization's exempt purpose. This tax is not imposed on activities related to the exempt purpose regardless of their competitive nature. Administering this tax can be difficult, as you have already heard today, because of the individual circumstances that must be considered to determine whether an activity is substantially related.

Third, IRS selection of unrelated business income tax returns for examination can be improved. Because IRS does not have information on those organizations least likely to comply with this tax, it cannot routinely identify the most noncompliant organizations for examination. For returns examined in fiscal years 1981 through 1983, 3 percent yielded 90 percent of the additional recommended assessments.

Data on the activities of tax-exempt organizations are limited. Data that are available indicate that the community has grown significantly over the years in numbers, types of activities, and financial resources and we include some specifics on that on page 3.

On page 4 we show that the available data on income-producing activities is not adequate to determine the extent of their reliance on these activities to generate revenues. But some IRS data show that tax-exempt organizations' other revenue sources, which include business receipts, interest and dividends, increased from 57 percent in 1946 to 75 percent in 1978. While the trend toward less reliance upon contributions seems pronounced among section 501(c)(3) organizations, some of these organizations, such as hospitals and educational institutions, have traditionally placed substantial reliance on charging fees for their services.

It now appears that some other nonprofits, such as social service agencies and humane societies, are also increasingly reliant on charging fees. The tax-exempt community views fees for services and expansion into income-producing activities, as a means of furthering exempt purposes. As reasons for the increase in these activities, they frequently cite reductions in government funds and increased demand for services, part of which they attribute to changes in Federal budget priorities.

Some business people told us that this increase in income-producing activities is a source of unfair competition. They believe that tax-exempt status and such benefits as reduced mailing rates, afford tax-exempt organizations a competitive advantage.

Our survey of members of the Business Coalition for Fair Competition and six industry groups that seem to voice the most concern about competition—audio-visual, racquet sports, research and testing, tour, travel, and veterinarians—showed varied perceptions as to the extent of competition. For example, 90 percent of racquet sports businesses, but only 45 percent of travel agencies, reported experiencing competition from one or more tax-exempt organizations. Members of the tax-exempt community also told us that competition, while not new, appears to be increasing. To them, competition has resulted more from taxable businesses entering traditionally tax-exempt areas than from tax-exempt organizations increasing income-producing activities.

Our survey indicated that 94 percent of racquet sports businesses and 42 percent of research and testing businesses, established their activities after 1970. Two major tax-exempt associations attribute this overall trend to third-party and government funding for social services, which they believe have made it profitable for taxable businesses to operate in traditionally tax-exempt areas. They point to day care, family counseling, and hospital services.

In addition to providing similar services, tax-exempt organizations are engaging in partnerships and joint ventures with taxable businesses. For example, charitable organizations have participated in real estate development projects with private sector partners to build and manage low-income and elderly housing. The concern is that a charitable organization's general partnership interests may conflict with the statutory requirement to operate exclusively for public, charitable purposes.

The next part of my statement is on the unrelated business income tax and its administration. Since prior witnesses have covered most of that, I will not repeat it but instead, skip over to page 12 of our statement where begins a section that deals with compliance with the UBIT and the work of the IRS Office of the Assistant Commissioner for Employee Plans and Exempt Organizations. As the Commissioner has mentioned this morning, tax-exempt organizations with annual gross receipts in excess of $25,000, except churches and certain church affiliates, are required to file the annual information return, the form 990. Any organizations that earn unrelated business gross income in excess of $1,000 must file the form 990-T and as you have already heard today, in calendar year 1986, tax-exempt organizations filed over 345,000 forms 990 and over 27,000 unrelated business income tax returns.

IRS program officials told us that when properly completed, forms 990 and 990–T are adequate to monitor the unrelated business income. However, they said that the information reported on the form 990 may not be as detailed as the instructions require, particularly as to the specific sources of income and the relationship to the exempt purposes of the organization. They also said that due to the complexity of the law, the 990–T, with its various schedules designed to reflect unrelated income, may be difficult for some organizations to complete, particularly those organizations that do not have professional accounting assistance. Our work did not identify any particular shortcomings with the 990–T that would hinder IRS compliance efforts.

In 1985, we reported that IRS could improve the examination selection system for unrelated business income tax returns. Under IRS procedures, unrelated business income tax returns are examined usually as part of routine examinations for overall tax exempt law compliance. IRS does not attempt to identify unrelated business income tax returns most in need of examination. Our analysis showed that IRS assessed about $42 million in additional tax and penalties as a result of examining 8,850 of the unrelated business income tax returns in fiscal years 1981 through 1983. However, 56 percent of those examinations yielded no additional assessments; 41 percent yielded about $4 million in additional assessments; and 3 percent yielded almost 90 percent, or about $38 million of the total $42 million in additional assessments.

Similarly, in fiscal year 1986, IRS examined more than 3,000 of those returns. These examinations resulted in additional recommended tax and penalties of over $57 million, $33 million of which resulted from the examination of two related organizations. The main issue in those two cases was acquisition indebtedness from real estate transactions. IRS officials told us that as a result of appeals, less than $1 million of that $33 million will be collected.

IRS does not have enough information on noncompliance with the unrelated business income tax. With more information on noncompliance, IRS could select and examine those returns with the most potential for noncompliance and in that way, IRS may promote greater compliance and assess similar or higher amounts of tax with fewer examinations. And as you have heard today, IRS agreed with us that more could be done to improve the selection and examination of these returns and IRS plans to begin a taxpayer compliance measurement program specifically for the form 990–T's.

In conclusion, Mr. Chairman, we again reiterate the lack of data that exists, as you have heard from all of the prior witnesses, and as a result of that, we all have difficulties making specific recommendations for changes. We do end with the statement that problems with the unrelated business income tax may be exacerbated in the future. Tax exempt organization members said that if they continue to experience decreases in government support, they may become even more reliant on private support or income-producing activities. Private support may decline in the future because recent tax law changes are expected to reduce the incentive for charitable giving. Therefore, tax exempt organizations will most likely rely more upon income-producing activities that might be subject to this tax, to fund their operations.

Mr. Chairman, that concludes my prepared statement. I have with me today on my right, Gerald Stankosky, who is a Group Director in our General Government Division and on my left, Jack Harrison, who is from our New York Regional Office. Jack was responsible for the report which we issued in February that is called Competition Between Taxable Businesses and Tax Exempt Organizations. We will be happy to answer your questions.

[The prepared statement follows:]

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its inquiry into the nature and extent of commercial and other income-producing activities of tax-exempt organizations and the use of the unrelated business income tax to deal with those activities. Our statement is based primarily upon work we have done in the unrelated business income area over the last several years for this Subcommittee and for the Joint Committee on Taxation.[1]

I would like to highlight three major points:

-- First, Internal Revenue Service (IRS) data, media reports, and information we gathered from the tax-exempt and taxable business communities indicate that tax-exempts are increasingly reliant on income-producing or commercial activities to generate revenue. However, there are no complete data to quantify the nature and extent of tax-exempt organizations' involvement in these activities and most of the data that are available are old. Consequently, it is difficult to determine if these activities are resulting in widespread competition between the taxable business and tax-exempt communities.

-- Second, in 1950, Congress established the unrelated business income tax that is imposed on commercial activities not substantially related to a tax-exempt organization's exempt purpose. This tax, however, is not imposed on activities related to the exempt purpose, regardless of their competitive nature. Administering this tax can be difficult because of the individual circumstances that must be considered to determine whether an activity is substantially related to an exempt purpose.

-- Third, IRS' selection of unrelated business income tax returns for examination can be improved. Because IRS does not have information on those organizations least likely to comply with this tax, it cannot routinely identify the most noncompliant organizations for examination. For returns examined in fiscal years 1981 through 1983, 3 percent yielded 90 percent of the additional recommended assessments.

TAX-EXEMPT ORGANIZATION ACTIVITIES

Data on the activities of tax-exempt organizations are limited. Data that are available indicate that the tax-exempt community has grown significantly over the years in numbers, types of activities, and financial resources. For example:

-- IRS' master file as of October 1986, included over 840,000 active tax-exempt organizations, not including religious organizations. They are exempt under 25 broad categories and report engaging in 1 or more of over 260 activities, such as educational, cultural, historical, and health service.

-- Internal Revenue Code section 501(c)(3) organizations, such as those engaged in charitable, religious, educational, and health activities, dominate the tax-exempt community. As of October 1986, about 44 percent of all tax-exempt organizations in IRS' Exempt Organization/ Business Master File were section 501(c)(3) organizations.

---

[1] Tax Policy: Competition Between Taxable Businesses and Tax-Exempt Organizations, GAO/GGD-87-40BR, February 27, 1987; IRS' Examination Selection System for Exempt Organizations' Unrelated Business Income, GAO/GGD-85-64, July 8, 1985; Statistical Data on Tax-Exempt Organizations Earning Unrelated Business Income, GAO/GGD-85-43, March 29, 1985.

-- A few large organizations have controlled the majority of assets and revenues. For example, a 1975 IRS study showed that 1 percent of all tax-exempt organizations accounted for about 60 percent of the community's total revenues.

Available data on the specific income-producing or commercial activities of tax-exempt organizations is not adequate to determine the extent of reliance of the tax-exempt community on these activities to generate revenues. These revenues include business receipts, interest, dividends, rents, royalties, and other income. However, a 1975 IRS study showed that about 50 percent of tax-exempt organizations filing returns reported revenues from business receipts. Other IRS data show that tax-exempt organizations' other revenue sources which include business receipts, interest, and dividends, increased from 57 percent in 1946 to 75 percent in 1978. In this same period, contributions decreased as a percent of total revenue from 17 percent to 13 percent. (See app. I.) Unfortunately, this is the most current overall aggregated data that we are aware of regarding tax-exempt organizations.

This trend toward less reliance upon contributions seems to be even more pronounced among section 501(c)(3) organizations, such as charitable, educational, and scientific organizations (see app. II). Some of these organizations, such as hospitals and educational institutions, have traditionally placed substantial reliance on charging fees for their services. However, it now appears that some other nonprofits, such as social service agencies and humane societies, are increasingly reliant on charging fees for services. We found that members of the tax-exempt community view fees for services and expansion into income-producing activities as a means of furthering their exempt purposes. As reasons for the increase in these activities, they frequently cite reductions in government funds and increased demand for services, part of which they attribute to changes in federal budget priorities.

Some business people told us that this apparent increase in income-producing activities is a source of unfair competition. They perceive that such activities exceed the traditional role of tax-exempt organizations. They believe that tax-exempt status and such benefits as reduced mailing rates afford tax-exempt organizations a competitive advantage. Our survey of members of the Business Coalition for Fair Competition and six industry groups that seemed to voice the most concern about competition--audio-visual, racquet sports, research and testing, tour, travel, and veterinarian--showed varied perceptions as to the extent of competition. For example, 90 percent of racquet sports businesses but only 45 percent of travel agencies reported experiencing competition from one or more tax-exempt organizations.

Members of the tax-exempt community told us that competition, while not new, appears to be increasing. To them, competition has resulted more from taxable businesses entering traditionally tax-exempt areas than from tax-exempt organizations increasing income-producing activities. Our survey indicated that 94 percent of the racquet sports businesses and 42 percent of the research and testing businesses established their activities after 1970. Two major tax-exempt associations attribute this overall trend to third-party and government funding for social services which they believe have made it profitable for taxable businesses to operate in traditionally tax-exempt areas. They point to day care, family counseling, and hospital services.

In addition to providing similar services as taxable businesses, tax-exempt organizations are engaging in commercial activities with taxable businesses through partnerships and joint ventures. For example, charitable organizations have participated in real estate development projects with private sector partners to build and manage low-income and elderly housing. IRS program officials are concerned that a charitable organization's general partnership interests may conflict with the statutory requirement that section 501(c)(3) organizations be operated exclusively for public, charitable purposes. IRS has issued General Counsel memoranda and private letter rulings on this issue. IRS has no accumulated data on the extent of such ventures, but plans to gather information on the unrelated business activity of these ventures as part of its planned Taxpayer Compliance Measurement Program for unrelated business income tax.

THE UNRELATED BUSINESS INCOME TAX AND ITS ADMINISTRATION

In 1950, Congress enacted legislation that imposed the unrelated business income tax--a tax on income from activities not substantially related to the tax-exempt organization's purpose. This legislation was to address a perceived unfair competitive advantage enjoyed by certain tax-exempt organizations and to prevent a potential loss of tax revenue. The tax was not imposed on income derived from any activity related to an organization's exempt purpose regardless of its competitive nature. For example, fees for medical services provided to patients in a tax-exempt hospital are not taxed.

The unrelated business income tax is imposed under Internal Revenue Code sections 511, 512, 513, and 514. Section 511 provides for a tax on unrelated business taxable income, 512 defines unrelated business taxable income, 513 defines an unrelated trade or business and 514 deals with income derived from debt-financed property. Under IRS regulations, for an activity to be subject to this tax, the following criteria apply:

-- It must be a trade or business. This is generally any activity carried on for the production of income from the sale of goods or the performance of services.

-- It must be regularly carried on. A trade or business is regularly carried on if it is similar to commercial activities of a nonexempt organization with respect to frequency, continuity, and manner of pursuit.

-- It must not be substantially related to the organization's exempt purpose. A trade or business is not substantially related if a causal relationship does not exist between the business and achievement of an exempt purpose. There is a substantial relationship when the business contributes importantly to the exempt purpose, other than through the production of income.

Congress has enacted many exceptions to the unrelated business income tax. The 1950 legislation, for example, excluded any activity

-- where substantially all work is performed without compensation;

-- which is carried on by a section 501(c)(3) organization primarily for the convenience of its members, students, patients, officers, or employees; or

-- that consists of selling contributed merchandise.

Income from these activities is not taxed regardless of any competition with taxable businesses, regularity of operation, or lack of relatedness to an exempt purpose. These exceptions were inserted to protect such activities as university dining halls and thrift shops that sell donated goods.

The 1950 legislation also excepted three categories of research--research for a government, research by colleges and hospitals for others, and in the case of an organization primarily conducting basic research, all research activities. In addition, various types of incomes were excluded: dividends, interest, annuities, royalties, rents from real and personal property (subject to exceptions), and capital gains and losses. The legislative history shows that Congress granted these exclusions because these types of income had "long been recognized as proper for educational and charitable organizations," and "investments of this sort are not likely to result in serious competition for taxable business having similar income." Other exceptions have been enacted over the years. Examples include the 1978 exception for bingo games when such games are not available on a commercial basis and the 1986 exception for the sale of mailing lists among charities.

In administering the unrelated business income tax, it is often difficult for IRS to determine whether the income-producing or commercial activity is not substantially related to the exempt purpose and therefore subject to the tax. IRS officials noted that there are no concrete rules for determining the relatedness of such activities to an organization's exempt purpose. Each income-producing activity must be considered in relation to the organization's exempt purpose.

For example, IRS initially ruled veterinary services offered for a fee by a humane society to be an ordinary commercial activity that had no causal relationship to the society's exempt purpose of preventing cruelty to animals. The fees were therefore subject to the tax. Subsequently, IRS redetermined that the veterinary services offered for a fee by this humane society were related to the organization's exempt purpose and not subject to the tax. Initially, IRS considered that the fee-for-service activity was too substantial in relation to the organization's other activities. Later, IRS redetermined that the organization had maintained a proper balance between its fee-for-service activities and its exempt purpose and did not aggressively promote the activities conducted for a fee.

Another problem associated with this tax is that once an activity is determined unrelated to the exempt purpose and therefore subject to the tax, accounting for the revenue and expenses associated with the unrelated activity is sometimes difficult. For example, when a tax-exempt organization conducts various types of activities, some tax-exempt and some subject to the tax, allocating the amount of income and expenses attributable to each activity can be difficult.

Business people told us that the unrelated business income tax is too ambiguous and contains too many exceptions to adequately address the competitive activities of tax-exempt organizations. They suggested various changes to the unrelated business income tax. For example:

-- Eliminate or restrict various exceptions that currently exist under the law.

-- Establish an allowable parameter for unrelated business income, such as a percent of total operating revenue that, when exceeded, would result in loss of tax-exempt status.

-- Establish competition as a criterion for determining the applicability of the unrelated business income tax.

-- Impose the highest marginal corporate tax rate on all income subject to this tax.

-- Revise the regulations to clarify what constitutes a substantially related business.

On the other hand, members of the tax-exempt community told us that the unrelated business income tax is the proper framework for determining the taxable income of tax-exempt organizations. They believe that IRS and national tax-exempt organization associations should provide more information to tax-exempt organizations on the unrelated business income tax requirements to avoid misunderstandings and incorrect returns.

COMPLIANCE WITH THE UNRELATED BUSINESS INCOME TAX

The Office of the Assistant Commissioner (Employee Plans and Exempt Organizations) has overall responsibility for monitoring compliance with the unrelated business income tax law. In general, tax-exempt organizations (except churches and certain church affiliates) with annual gross receipts in excess of $25,000 are required to file an annual information return--Form 990 (see app. III). Any organizations that earn unrelated business gross income in excess of $1,000 must file Form 990-T (see app. IV).

In calendar year 1986, tax-exempt organizations filed over 345,000 Forms 990 and over 27,000 unrelated business income tax returns--Forms 990-T (see app. V for the numbers of Forms 990 and 990-T filed during the last three calendar years). IRS program officials told us that when properly completed, Forms 990 and 990-T are adequate to monitor unrelated business income. However, these officials said that the information reported on the Form 990 may not be as detailed as the instructions require, particularly as to the specific sources of income and the relationship of such income to the exempt purposes of the organization. They also said that due to the complexity of the law, the 990-T, with its various schedules designed to reflect unrelated business income, may be difficult for some organizations to complete--particularly those organizations that do not have professional accounting assistance. Our work did not identify any particular shortcomings with the Form 990-T that would hinder IRS' compliance efforts.

In 1985 we reported (GAO/GGD-85-64) that IRS could improve the examination selection system for unrelated business income tax returns. Under IRS' procedures, unrelated business income tax returns are examined usually as part of routine examinations for overall tax-exempt law compliance. IRS does not attempt to identify unrelated business income tax returns most in need of examination. Our analysis showed that IRS assessed about $42 million in additional tax and penalties as a result of examining 8,850 unrelated business income returns in fiscal years 1981 through 1983. However, 56 percent of these examinations yielded no additional assessments; 41 percent yielded about $4 million in additional assessments; and 3 percent yielded almost 90 percent, or about $38 million, of the total of $42 million in additional assessments.

Similarly, in fiscal year 1986, IRS examined 3,324 unrelated business income tax returns. These examinations resulted in additional recommended tax and penalties of over $57 million, $33 million of which resulted from the examination of two related organizations. The main issue in these two cases was acquisition indebtedness from real estate transactions. IRS officials told us that as a result of appeals, less than $1 million of this $33 million would be collected. (App. VI shows the number of examinations for unrelated business income by 501(c) category for fiscal years 1985 and 1986. App. VII shows the various types of unrelated business activities and associated IRS codes which are used for reporting purposes.)

IRS does not have enough information on noncompliance with the unrelated business income tax. With more information on noncompliance, IRS could select and examine those unrelated business income tax returns with the most potential for noncompliance. In that way, IRS may promote greater compliance and assess similar or higher amounts of tax with fewer examinations.

IRS agreed with us that more could be done to improve the selection and examination of unrelated business income tax returns. In fiscal year 1988, IRS plans to begin a Taxpayer Compliance Measurement Program specifically for unrelated business income. This effort should result in better information on the nature and extent of unrelated business income and compliance with the unrelated business income tax. This program is scheduled for completion in fiscal year 1992. In the interim, IRS is collecting some limited data from a sample of unrelated business income tax returns. The main purpose is to get a better idea of the gross income, expenses, and other monetary amounts reported by tax-exempt organizations that earn unrelated business income.

CONCLUSION

Tax-exempt organizations appear to be increasingly reliant on income-producing or commercial activities to generate revenues. Various business people are concerned about the increase in these activities, especially those activities not subject to the unrelated business income tax. By law, the unrelated business income tax is imposed on income-producing activities if they are not substantially related to the exempt purpose. The tax is not imposed on activities that are substantially related to the exempt purpose, regardless of whether they compete with taxable businesses. Currently, complete data do not exist to measure the nature and extent of such income-producing activities and to show how significant the competition is between the taxable business and tax-exempt communities. Without such information, it is difficult to determine whether any changes are needed in the unrelated business income tax to address the competition issue.

Problems with administering the unrelated business income tax may be exacerbated in the future. Tax-exempt organization members said if they continue to experience decreases in government support, they may become even more reliant on private support and income-producing activities to generate revenue. Private support may decline in the future because recent tax law changes are expected to reduce the incentive for charitable giving. Therefore, tax-exempt organizations will most likely rely more upon income-producing or commercial activities that might be subject to this tax to fund their operations.

This concludes my prepared statement. We would be pleased to respond to your questions.

Major Revenue Sources for 1946, 1975, 1977, and 1978 (amounts in billions)

Year	Contributions amount	Contributions percent	Dues and assessments amount	Dues and assessments percent	Other revenue amount	Other revenue percent	Total amount	Total percent
1946	$ .6	17	$ .9	26	$ 2.0	57	$ 3.5	100
1975	20.5	18	19.3	17	74.8	65	114.6	100
1977	24.0	14	24.7	14	127.8	72	176.5	100
1978	31.3	13	29.1	12	178.0	75	238.4	100

Source: Data for 1946, 1977, and 1978 are based upon returns filed with IRS for those years. Data for 1975 are estimates based upon an IRS Statistics of Income Division statistical sample.

Major Revenue Sources for Section 501(c)(3) Organizations in 1946, 1975, and 1982

	1946		1975[a]		1982	
Source of revenue	Amount (000)	Percent of total	Amount (000)	Percent of total	Amount (000)	Percent of total
Contributions	$ 446,227	36	$18,326,410	27	$ 41,272,718	18
Dues and assessments	61,990	5	1,530,659	2	2,476,708	1
Other	741,074	59	48,950,500	71	190,460,291	81
Total revenue	$1,249,291	100	$68,807,569	100	$234,209,717	100

Source: IRS Statistics of Income Division studies.

[a] Includes private foundations.

APPENDIX III

APPENDIX III

Form **990**

Department of the Treasury
Internal Revenue Service

Return of Organization Exempt From Income Tax

Under section 501(c) (except black lung benefit trust or private foundation) of the Internal Revenue Code or section 4947(a)(1) trust

Note: You may be required to use a copy of this return to satisfy state reporting requirements. See instruction D.

OMB No. 1545 0047

1986

For the calendar year 1986, or fiscal year beginning , 1986, and ending , 19

Use IRS label. Otherwise, please print or type.	Name of organization	**A Employer identification number** (see instruction L)
	Address (number and street)	**B State registration number** (see instruction D)
	City or town, state, and ZIP code	**C** Section 4947(a)(1) trusts filing this form in lieu of Form 1041, check here ▶ ☐ (see instruction C10)

D Check type of organization—Exempt under section ▶ ☐ 501(c) ( ) (insert number), OR ▶ ☐ section 4947(a)(1) trust

E Accounting method: ☐ Cash ☐ Accrual ☐ Other (specify) ▶

Check here if application for exemption is pending ▶ ☐

F Is this a group return (see instruction J) filed for affiliates? ☐ Yes ☐ No
If "Yes," enter the number of affiliates for which this return is filed ____
Is this a separate return filed by a group affiliate? ☐ Yes ☐ No

G If "Yes" to either, give four-digit group exemption number (GEN) ▶

H ☐ Check here if your gross receipts are normally not more than $25,000 (see instruction B11). You do not have to file a completed return with IRS but should file a return without financial data if you were mailed a Form 990 Package (see instruction A). Some states may require a completed return.

I ☐ Check here if gross receipts are normally more than $25,000 and line 12 is $25,000 or less. Complete Parts I (except lines 13-15), III, IV, VI, and VII and only the indicated items in Parts II and V (see instruction I). If line 12 is more than $25,000, complete the entire return.

501(c)(3) organizations and 4947(a)(1) trusts must also complete and attach Schedule A (Form 990). (See instructions.)

Part I Statement of Support, Revenue, and Expenses and Changes in Fund Balances

					(A) Total	These columns are optional—see instructions (B) Unrestricted/Expendable	(C) Restricted/Nonexpendable
Support and Revenue	1	Contributions, gifts, grants, and similar amounts received:					
	a	Direct public support					
	b	Indirect public support					
	c	Government grants					
	d	Total (add lines 1a through 1c) (attach schedule—see instructions)					
	2	Program service revenue (from Part IV, line f)					
	3	Membership dues and assessments					
	4	Interest on savings and temporary cash investments					
	5	Dividends and interest from securities					
	6a	Gross rents					
	b	Minus: rental expenses					
	c	Net rental income (loss)					
	7	Other investment income (Describe ▶)					
			Securities	Other			
	8a	Gross amount from sale of assets other than inventory					
	b	Minus: cost or other basis and sales expenses					
	c	Gain (loss) (attach schedule)					
	9	Special fundraising events and activities (attach schedule—see instructions):					
	a	Gross revenue (not including $ ____ of contributions reported on line 1a)					
	b	Minus: direct expenses					
	c	Net income (line 9a minus line 9b)					
	10a	Gross sales minus returns and allowances					
	b	Minus: cost of goods sold (attach schedule)					
	c	Gross profit (loss)					
	11	Other revenue (from Part IV, line g)					
	12	Total revenue (add lines 1d, 2, 3, 4, 5, 6c, 7, 8c, 9c, 10c, and 11)					
Expenses	13	Program services (from line 44, column (B)) (see instructions)					
	14	Management and general (from line 44, column (C)) (see instructions)					
	15	Fundraising (from line 44, column (D)) (see instructions)					
	16	Payments to affiliates (attach schedule—see instructions)					
	17	Total expenses (add lines 16 and 44, column (A))					
Fund Balances	18	Excess (deficit) for the year (subtract line 17 from line 12)					
	19	Fund balances or net worth at beginning of year (from line 74, column (A))					
	20	Other changes in fund balances or net worth (attach explanation)					
	21	Fund balances or net worth at end of year (add lines 18, 19, and 20)					

For Paperwork Reduction Act Notice, see page 1 of the instructions.

Form **990** (1986)

Form 990 (1986) Page 2

Part II Statement of Functional Expenses

All organizations must complete column (A). Columns (B), (C), and (D) are required for most sections 501(c)(3) and (c)(4) organizations and 4947(a)(1) trusts but optional for others. (See instructions.)

	Do not include amounts reported on lines 6b, 8b, 9b, 10b, or 16 of Part I.	(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
Expenses 22	Grants and allocations (attach schedule)			▨	▨
23	Specific assistance to individuals			▨	▨
24	Benefits paid to or for members			▨	▨
25	Compensation of officers, directors, etc.				
26	Other salaries and wages				
27	Pension plan contributions				
28	Other employee benefits				
29	Payroll taxes				
30	Professional fundraising fees		▨	▨	
31	Accounting fees				
32	Legal fees				
33	Supplies				
34	Telephone				
35	Postage and shipping				
36	Occupancy				
37	Equipment rental and maintenance				
38	Printing and publications				
39	Travel				
40	Conferences, conventions, and meetings				
41	Interest				
42	Depreciation, depletion, etc. (attach schedule)				
43	Other expenses (itemize): a				
b					
c					
d					
e					
f					
44	Total functional expenses (add lines 22 through 43) Organizations completing columns B-D, carry these totals to lines 13-15.				

Part III Statement of Program Services Rendered

	List each program service title on lines a through d; for each, identify the service output(s) or product(s), and report the quantity provided. Enter the total expenses attributable to each program service and the amount of grants and allocations included in that total. (See instructions for Part III.)	Expenses (Optional for some organizations—see instructions)
a	(Grants and allocations $)	
b	(Grants and allocations $)	
c	(Grants and allocations $)	
d	(Grants and allocations $)	
e	Other program service activities (attach schedule) (Grants and allocations $)	
f	Total (add lines a through e) (should equal line 44, column (B))	

Form 990 (1986) Page 3

Part IV Program Service Revenue and Other Revenue (State Nature)

	Program service revenue	Other revenue
a Fees from government agencies		
b		
c		
d		
e		
f Total program service revenue (enter here and on line 2)		▨
g Total other revenue (enter here and on line 11)		

Part V Balance Sheets

If line 12 or Column (B) of line 59 is more than $25,000, complete the entire balance sheet. If line 12, Part I, and Column (B) of line 59 are $25,000 or less, you may complete only lines 59, 66, 74, and 75. See instructions.

Note: **Columns (C) and (D) are optional.** *Columns (A) and (B) must be completed to the extent applicable. Where required, attached schedules should be for end-of-year amounts only.*	(A) Beginning of year	End of year		
		(B) Total	(C) Unrestricted/ Expendable	(D) Restricted Nonexpendable
Assets				
45 Cash—non-interest bearing				
46 Savings and temporary cash investments				
47 Accounts receivable ▶ ______				
minus allowance for doubtful accounts ▶ ______				
48 Pledges receivable ▶ ______				
minus allowance for doubtful accounts ▶ ______				
49 Grants receivable				
50 Receivables due from officers, directors, trustees, and key employees (attach schedule)				
51 Other notes and loans receivable ▶ ______				
minus allowance for doubtful accounts ▶ ______				
52 Inventories for sale or use				
53 Prepaid expenses and deferred charges				
54 Investments—securities (attach schedule)				
55 Investments—land, buildings and equipment: basis ▶ ______				
minus accumulated depreciation ▶ ______ (attach schedule)				
56 Investments—other (attach schedule)				
57 Land, buildings and equipment: basis ▶ ______				
minus accumulated depreciation ▶ ______ (attach schedule)				
58 Other assets ▶ ______				
59 Total assets (add lines 45 through 58)				
Liabilities				
60 Accounts payable and accrued expenses				
61 Grants payable				
62 Support and revenue designated for future periods (attach schedule)				
63 Loans from officers, directors, trustees, and key employees (attach schedule)				
64 Mortgages and other notes payable (attach schedule)				
65 Other liabilities ▶ ______				
66 Total liabilities (add lines 60 through 65)				
Fund Balances or Net Worth				
Organizations that use fund accounting, check here ▶ ☐ and complete lines 67 through 70 and lines 74 and 75.				
67a Current unrestricted fund				
b Current restricted fund				
68 Land, buildings and equipment fund				
69 Endowment fund				
70 Other funds (Describe ▶ ______)				
Organizations that do not use fund accounting, check here ▶ ☐ and complete lines 71 through 75.				
71 Capital stock or trust principal				
72 Paid-in or capital surplus				
73 Retained earnings or accumulated income				
74 Total fund balances or net worth (see instructions)				
75 Total liabilities and fund balances/net worth (see instructions)				

Part VI **List of Officers, Directors, and Trustees (List each officer, director, and trustee whether compensated or not.) (See instructions.)**

(A) Name and address	(B) Title and average hours per week devoted to position	(C) Compensation (if any)	(D) Contributions to employee benefit plans	(E) Expense account and other allowances

Part VII **Other Information** — Yes | No

76 Has the organization engaged in any activities not previously reported to the Internal Revenue Service?
If "Yes," attach a detailed description of the activities.

77 Have any changes been made in the organizing or governing documents, but not reported to IRS?
If "Yes," attach a conformed copy of the changes.

78 a Did the organization have unrelated business gross income of $1,000 or more during the year covered by this return?

b If "Yes," have you filed a tax return on Form 990-T, Exempt Organization Business Income Tax Return, for this year?

c If the organization has gross sales or receipts from business activities not reported on Form 990-T, attach a statement explaining your reason for not reporting them on Form 990-T.

79 Was there a liquidation, dissolution, termination, or substantial contraction during the year? (See instructions.)
If "Yes," attach a statement as described in the instructions.

80 Is the organization related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization? (See instructions.)
If "Yes," enter the name of the organization ▶ ....
.... and check whether it is ☐ exempt **OR** ☐ nonexempt

81 a Enter amount of political expenditures, direct or indirect, as described in the instructions

b Did you file Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations, for this year?

82 Did your organization receive donated services or the use of materials, equipment, or facilities at no charge or at substantially less than fair rental value?
If "Yes," you may indicate the value of these items here. Do not include this amount as support in Part I or as an expense in Part II. See instructions for reporting in Part III ▶

83 *Section 501(c)(5) or (6) organizations.*—Did the organization spend any amounts in attempts to influence public opinion about legislative matters or referendums? (See instructions and Regulations section 1.162-20(c).)
If "Yes," enter the total amount spent for this purpose

84 *Section 501(c)(7) organizations.*—Enter amount of:

a Initiation fees and capital contributions included on line 12

b Gross receipts, included in line 12, for public use of club facilities (see instructions)

c Does the club's governing instrument or any written policy statement provide for discrimination against any person because of race, color, or religion? (See instructions.)

85 *Section 501(c)(12) organizations.*—Enter amount of:

a Gross income received from members or shareholders

b Gross income received from other sources (do not net amounts due or paid to other sources against amounts due or received from them)

86 *Public interest law firms.*—Attach information described in the instructions.

87 List the states with which a copy of this return is filed ▶ ....

88 During this tax year did you maintain any part of your accounting/tax records on a computerized system?

89 The books are in care of ▶ .... Telephone no. ▶ ....
Located at ▶

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge

▶ Signature of officer Date ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ Date Check if self-employed ▶

Firm's name (or yours, if self-employed) and address ▶ ZIP code

Form **990-T**
Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return

(Under Section 511 of the Internal Revenue Code) For calendar year 1986 or other tax year beginning .... 1986, and ending .... 19 .....

OMB No 1545-0687

1986

Name of organization

Address (number and street)

City or town, state, and ZIP code

A **Employer identification number** (employees' trust see instruction for Block A)

B Enter unrelated business activity codes from page 12 of instructions

C Check box if address changed . . . . ▶ ☐ **D** Exempt under section . . . ▶ 501 ( ) ( )

E Check type of organization ▶ ☐ Corporation ☐ Trust ☐ Section 401(a) trust

F Group exemption number (see instructions for Block F) ▶

If the unrelated trade or business gross income is $10,000 or less, complete only page 1 and Part III on page 2, and sign the return. Complete all applicable parts of the form (except lines 1 through 4) if unrelated trade or business gross income is over $10,000.

Taxable Income

1	Unrelated trade or business gross income (state sources ▶ ....)	1	
2	Deductions (including net operating loss) (complete Parts I and II instead of lines 1, 2, 3, and 4 if you have gross income over $10,000)	2	
3	Unrelated business taxable income before specific deduction (subtract line 2 from line 1)	3	
4	Specific deduction (see instructions)	4	
5	Unrelated business taxable income (subtract line 4 from line 3 or enter amount from line 33, page 2. If line 4 is greater than line 3, enter the lesser of zero or line 3.)	5	

Tax Computation

Organizations Taxable as Corporations (See Instructions for Tax Computation)

6a Check if you are a member of a controlled group (see sections 1561 and 1563) . . . . . . ☐

b If checked, see instructions and enter your share of the $25,000 in each taxable income bracket:
(i) $ .... (ii) $ .... (iii) $ .... (iv) $ ....

c If checked and your tax year includes July 1, 1987, enter share of tax bracket amounts:
(i) $ .... (ii) $ ....

7	Income tax on amount on line 5, above. Check here ▶ ☐ if alternative tax is used	7	

Trusts Taxable at Trust Rates (See Instructions for Tax Computation)

8	Enter the tax from the tax rate schedule in the instructions on the amount on line 5	8	

Total Income Tax

9a	Foreign tax credit (corporations attach Form 1118, trusts attach Form 1116)	9a			
b	Other credits (see instructions)	9b			
c	General business credit.—Check if from __ Form 3800 __ Form 3468 __ Form 6478 __ Form 6765 __ Form 8586	9c			
10	Total (add lines 9a through 9c)			10	
11	Subtract line 10 from line 7 or line 8			11	
12	Tax from recomputing prior year investment credit (attach Form 4255)			12	
13	Minimum tax on tax preference items (Corporations only—see instructions)			13	
14	Alternative minimum tax (Trusts only–see instructions)			14	
15	Total tax (add lines 11 through 14)			15	
16	Credits and payments:				
a	Tax deposited with Form 7004 or Form 2758	16a			
b	Foreign organizations—Tax paid or withheld at the source (see instructions)	16b			
c	Credit from regulated investment companies (attach Form 2439)	16c			
d	Credit for Federal tax on gasoline and special fuels (attach Form 4136)	16d			
e	Other credits and payments (see instructions)	16e			
17	Total credits and payments (add lines 16a through 16e)			17	
18	**TAX DUE** (subtract line 17 from line 15) See instructions for depositary method of payment ▶			18	
19	**OVERPAYMENT** (subtract line 15 from line 17) ▶			19	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge

▶ Signature of officer Date ▶ Title

Paid Preparer's Use Only

Preparer's signature ▶ Date Check if self-employed ▶ ☐ Preparer's social security no

Firm's name (or yours, if self-employed) and address ▶ E.I. No ▶ ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of instructions. Form **990-T** (1986)

Form 990-T (1986) 2

Part I Unrelated Trade or Business Income

1a	Gross receipts or sales .... b Less returns and allowances .... Balance ▶	1c	
2	Cost of goods sold and/or operations (Schedule A)	2	
3	Gross profit (subtract line 2 from line 1c)	3	
4a	Capital gain net income (attach separate Schedule D) (see instructions)	4a	
b	Net gain or (loss) from Part II, Form 4797 (attached)	4b	
c	Capital loss deduction for trusts	4c	
5	Income or (loss) from partnerships (attach statement)	5	
6	Rent income (Schedule C)	6	
7	Unrelated debt-financed income (Schedule E, line 2)	7	
8	Investment income of a section 501(c)(7), (9), (17) or (20) organization (Schedule F)	8	
9	Interest, annuities, royalties, and rents from controlled organizations (Schedule G)	9	
10	Exploited exempt activity income (Schedule H)	10	
11	Advertising income (Schedule I, Part III, Column A)	11	
12	Other income (see instructions for line 12—attach schedule)	12	
13	TOTAL—Unrelated trade or business income (add lines 3 through 12)	13	

Part II Deductions Not Taken Elsewhere
(Except for contributions, deductions must be directly connected with the unrelated business income.)

14	Compensation of officers, directors, and trustees (Schedule J)			14	
15	Salaries and wages			15	
16	Repairs (see instructions)			16	
17	Bad debts (see instructions)			17	
18	Interest (attach schedule)			18	
19	Taxes			19	
20	Contributions (see instructions)			20	
21	Depreciation (attach Form 4562)	21		▨	
22	Less depreciation claimed in Schedule A and elsewhere on return	22a		22b	
23	Depletion			23	
24a	Contributions to deferred compensation plans (see instructions)			24a	
b	Employee benefit programs (see instructions)			24b	
25	Other deductions (attach schedule)			25	
26	TOTAL DEDUCTIONS (add lines 14 through 25)			26	
27	Unrelated business taxable income before allowable advertising loss (subtract line 26 from line 13)			27	
28	Advertising loss (Schedule I, Part III, Column B)			28	
29	Unrelated business taxable income before net operating loss deduction (subtract line 28 from line 27)			29	
30	Net operating loss deduction (see instructions)			30	
31	Unrelated business taxable income before specific deduction (subtract line 30 from line 29)			31	
32	Specific deduction (see instructions for line 4 of page 1)			32	
33	Unrelated business taxable income (subtract line 32 from line 31. If line 32 is greater than line 31, enter the lesser of zero or line 31.) Enter here and on page 1, line 5			33	

SCHEDULE A—COST OF GOODS SOLD AND/OR OPERATIONS
(See Instructions for Part I, line 2)

Method of inventory valuation (specify) ▶

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Other costs (attach schedule)	4	
5	TOTAL—Add lines 1 through 4	5	
6	Inventory at end of year	6	
7	Cost of goods sold and/or operations. Subtract line 6 from line 5. (Enter here and on line 2, Part I.)	7	

Part III Statements Regarding Certain Activities and Other Information

		Yes	No
1	At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account) (see page 9 of the instructions for exceptions and filing requirements for TD F 90-22.1)?		
	If "Yes," write in the name of the foreign country ▶	▨	▨
2	Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you had any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		

The books are in care of ▶ Telephone number ▶

Form 990-T (1986) Page 3

SCHEDULE C—RENT INCOME FROM REAL PROPERTY AND PERSONAL PROPERTY LEASED WITH REAL PROPERTY

(See Instructions for Part I, line 6)

1. Description of property	2. Rent received or accrued	3. Percentage of rent for personal property
		%
		%
		%
		%
		%

4. Complete for any item if the entry in column 3 is more than 50%, or if the rent is based on profit or income		5. Complete for any item if the entry in column 3 is more than [illegible] but not more than 50%		
(a) Deductions directly connected (Attach schedule)	(b) Income includible (Column 2 minus column 4(a))	(a) Gross income reportable (Column 2 x column 3)	(b) Deductions directly connected with personal property (Attach schedule)	(c) Income includible (Column 5(a) minus column 5(b))

Add columns 4(b) and 5(c) and enter total here and on line 6, Part I, page 2

SCHEDULE E—UNRELATED DEBT-FINANCED INCOME (See Instructions for Part I, line 7)

1. Description of debt-financed property	2. Gross income from or allocable to debt-financed property	3. Deductions directly connected with or allocable to debt-financed property	
		(a) Straight-line depreciation (Attach schedule)	(b) Other deductions (Attach schedule)
1			

4. Amount of average acquisition indebtedness on or allocable to debt-financed property (Attach schedule)	5. Average adjusted basis of or allocable to debt-financed property (Attach schedule)	6. Percentage which col 4 is of col 5	7. Gross income reportable (Column 2 x column 6)	8. Allocable deductions (Column 6 x total of columns 3(a) and 3(b))	9. Net income (or loss) includible (Column 7 minus column 8)
		%			
		%			
		%			
		%			

2 Total (enter here and on line 7, Part I, page 2) . . . .

3 Total dividends-received deductions included in column 8 . . . .

SCHEDULE F—INVESTMENT INCOME OF A SECTION 501(c)(7), (9), (17) OR (20) ORGANIZATION

(See Instructions for Part I, line 8)

1. Description	2. Amount	3. Deductions directly connected (Attach schedule)	4. Net investment income (Column 2 minus column 3)	5. Set-asides (Attach schedule)	6. Balance of investment income (Column 4 minus column 5)

Total (enter here and on line 8, Part I, page 2) . . . .

SCHEDULE G—INCOME (ANNUITIES, INTEREST, RENTS AND ROYALTIES) FROM CONTROLLED ORGANIZATIONS

(See Instructions for Part I, line 9)

1. Name and address of controlled organization(s)	2. Gross income from controlled organization(s)	3. Deductions of controlling organization directly connected with column 2 income (Attach schedule)	4. Exempt controlled organizations		
			(a) Unrelated business taxable income	(b) Taxable income computed as though not exempt under sec. 501(a) or the amount in col. (a), whichever is more	(c) Percentage which col. (a) is of col. (b)
					%
					%
					%

5. Nonexempt controlled organizations			6. Gross income reportable (Column 2 x column 4(c) or column 5(c))	7. Allowable deductions (Column 3 x column 4(c) or column 5(c))	8. Net income includible (Column 6 minus column 7)
(a) Excess taxable income	(b) Taxable income, or amount in column (a), whichever is more	(c) Percentage which col. (a) is of col. (b)			
		%			
		%			
		%			

Total (enter here and on line 9, Part I, page 2)

SCHEDULE H—EXPLOITED EXEMPT ACTIVITY INCOME, OTHER THAN ADVERTISING INCOME

(See Instructions for Part I, line 10)

1. Description of exploited activity	2. Gross unrelated business income from trade or business	3. Expenses directly connected with production of unrelated business income	4. Net income from unrelated trade or business (Column 2 minus column 3)	5. Gross income from activity that is not unrelated business income	6. Expenses attributable to column 5	7. Excess exempt expenses (Column 6 minus column 5, but not more than column 4)	8. Net income includible (Column 4 minus column 7)
Total (enter here and on line 10, Part I, page 2)							

SCHEDULE I—ADVERTISING INCOME AND ADVERTISING LOSS (See Instructions for Part I, line 11)

Part I Income From Periodicals Reported on Consolidated Basis

1. Name of periodical	2. Gross advertising income	3. Direct advertising costs	4. Advertising gain or loss (col. 2 minus col. 3). If loss, enter in col. B, Part III. Do not complete cols. 5, 6 and 7. If gain, complete cols. 5, 6 and 7	5. Circulation income	6. Readership costs	7. If col. 5 exceeds col. 6, enter in col. A, Part III, the gain shown in col. 4. If col. 6 exceeds col. 5, subtract col. 6 plus col. 3 from col. 5 plus col. 2. Enter gain in col. A, Part III
Totals						

Part II Income From Periodicals Reported on a Separate Basis

Part III Column A—Advertising Income

(a) Enter "consolidated periodical" or names of non-consolidated periodicals	(b) Enter total amount from column 4 or 7, Part I, and amounts listed in cols. 4 and 7, Part II
Enter total here and on line 11, Part I, page 2	

Part III Column B—Advertising Loss

(a) Enter "consolidated periodical" or names of non-consolidated periodicals	(b) Enter total amount from column 4, Part I, and amounts listed in column 4, Part II
Enter total here and on line 28, Part II, page 2	

SCHEDULE J—COMPENSATION OF OFFICERS, DIRECTORS, AND TRUSTEES

1. Name	2. Title	3. Percent of time devoted to business	4. Compensation attributable to unrelated business
		%	
		%	
		%	
		%	
		%	
		%	
Total (enter here and on line 14, Part II, page 2)			

Form 990 and 990-T Returns Filed in 1984, 1985, and 1986

Calendar (filing) year	Number of Forms 990 filed	Number of Forms 990-T filed[a]
1984	300,250	21,119
1985	345,473	23,433
1986	345,141	27,379

Source: IRS Exempt Organization/Business Master File

[a] Includes Forms 990-T filed by section 401(a) pension trusts.

Examination of 990-T Tax Returns by 501(c) Categories in Fiscal Years 1985 and 1986

Category and description[a]		Number of 990-T returns examined in: FY 1985	FY 1986
501(c)(2)	Title-holding corporations organized to hold title to property of an exempt organization, collect the income, and deliver the net proceeds to the exempt organization.	30	49
501(c)(3)	Entities organized and operated exclusively for religious and charitable, scientific, testing for public safety, literacy, or educational purposes; or for the prevention of cruelty to children or animals, or to foster amateur sports.	601	687
501(c)(4)	Civic leagues or organizations operated exclusively for the promotion of social welfare or local associations of employees (earnings devoted to charitable, educational, or recreational purposes).	194	257
501(c)(5)	Labor, agricultural, and horticultural organizations organized to provide education and instruction on improving working conditions and products.	169	174

Category and description	Number of 990-T returns examined for FY 1985	FY 1986
501(c)(6) Business leagues, chambers of commerce, real estate boards, and professional football leagues organized to improve business conditions.	499	616
501(c)(7) Clubs organized for pleasure and recreational purposes.	954	1,101
501(c)(8) Fraternal beneficiary societies and associations organized to provide for the payment of life, sickness, accident, or other benefits to members and operated under a framework of self-governing branches chartered by a parent organization.	187	217
501(c)(9) through (c)(23)	151	223
Total 990-T returns examined	2,785	3,324

Source: Internal Revenue Code and IRS Exempt Organization Automated Information Management System tables.

[a] According to IRS, 501(c)(1) organizations are not subject to UBIT and do not file Forms 990-T.

Unrelated Business Activities and Associated IRS Codes

AGRICULTURE, FORESTRY, AND FISHING

Code	
0400	Agricultural production
0800	Agricultural services (except veterinarians), forestry, fishing, hunting, and trapping

MINING

Metal mining:

1010	Iron ores
1070	Copper, lead and zinc, gold and silver ores
1098	Other metal mining
1150	Coal mining

Oil and gas extraction:

1330	Crude petroleum, natural gas, and natural gas liquids
1380	Oil and gas field services

Nonmetallic minerals (except fuels) mining:

1430	Dimension, crushed and broken stone, sand and gravel
1498	Other nonmetallic minerals, except fuels

CONSTRUCTION

General building contractors and operative builders:

1510	General building contractors
1531	Operative builders
1600	Heavy construction contractors

Special trade contractors:

1711	Plumbing, heating, and air conditioning
1731	Electrical work
1798	Other special trade contractors

MANUFACTURING

Food and kindred products:

2010	Meat products
2020	Dairy products
2030	Preserved fruits and vegetables
2040	Grain mill products
2050	Bakery products
2060	Sugar and confectionery products
2081	Malt liquors and malt
2088	Alcoholic beverages, except malt liquors and malt
2089	Bottled soft drinks and flavorings
2096	Other food and kindred products
2100	Tobacco manufacturers

Textile mill products:

2228	Weaving mills and textile finishing
2250	Knitting mills
2298	Other textile mill products

Apparel and other textile products:

2315	Men's and boys' clothing
2345	Women's and children's clothing
2388	Hats, caps, millinery, fur goods, and other apparel and accessories
2390	Misc. fabricated textile products

Lumber and wood products, except furniture:

2415	Logging camps and logging contractors, sawmills, and planing mills
2430	Millwork, plywood, and related products
2498	Other wood products including wood buildings and mobile homes
2500	Furniture and fixtures

Paper and allied products:

2625	Pulp, paper, and board mills
2699	Other paper products

Printing, publishing, and allied industries:

2710	Newspapers
2720	Periodicals
2735	Books, greeting cards, and misc. publishing
2799	Commercial and other printing, and printing trade services

Chemicals and allied products:

2815	Industrial chemicals, plastics materials and synthetics
2830	Drugs
2840	Soap, cleaners, and toilet goods
2850	Paints and allied products
2898	Agricultural and other chemical products

Petroleum refining and related industries (including those integrated with extraction):

2910	Petroleum refining (including those integrated with extraction)
2998	Other petroleum and coal products

Rubber and misc. plastics products:

3050	Rubber products: plastics footwear, hose and belting
3070	Misc. plastics products

Leather and leather products:

3140	Footwear, except rubber
3198	Other leather and leather products

Stone, clay, glass, and concrete products:

3225	Glass products
3240	Cement, hydraulic
3270	Concrete, gypsum, and plaster products
3298	Other nonmetallic mineral products

Primary metal industries:

3370	Ferrous metal industries; misc. primary metal products
3380	Nonferrous metal industries

Fabricated metal products, except machinery and transportation equipment:

Code	
3410	Metal cans and shipping containers
3428	Cutlery, hand tools, and hardware; screw machine products, bolts, and similar products
3430	Plumbing and heating, except electric and warm air
3440	Fabricated structural metal products
3460	Metal forgings and stampings
3470	Coating, engraving, and allied services
3480	Ordnance and accessories, except vehicles and guided missiles
3490	Misc. fabricated metal products

Machinery, except electrical:

3520	Farm machinery
3530	Construction, mining and materials handling machinery and equipment
3540	Metalworking machinery
3550	Special industry machinery, except metalworking machinery
3560	General industrial machinery
3570	Office, computing, and accounting machines
3598	Engines and turbines, service industry machinery, and other machinery, except electrical

Electrical and electronic machinery, equipment, and supplies:

3630	Household appliances
3665	Radio, television, and communication equipment
3670	Electronic components and accessories
3698	Other electric equipment

Transportation equipment:

3710	Motor vehicles and equipment
3725	Aircra [illegible] missiles and parts
3730	Shi [illegible] building and repairing
3798	Othe [illegible] rtation equipment

Measuring a [illegible] lling instruments; photographic and medica [illegible] watches and clocks:

3815	Scie [illegible] ruments and measuring dev [illegible] es and clocks
3845	Op [illegible] al, and ophthalmic goods
3860	Photog [illegible] equipment and supplies
3998	Other [illegible] anufacturing products

TRANSPORTATION, COMMUNICATION, ELECTRIC, GAS, AND SANITARY SERVICES

Transportation:

4000	Railroad transportation
4100	Local and interurban passenger transit
4200	Trucking and warehousing
4400	Water transportation
4500	Transportation by air
4600	Pipe lines, except natural gas
4700	Other transportation services

Communication:

4825	Telephone, telegraph, and other communication services
4830	Radio and television broadcasting

Electric, gas, and sanitary services:

4910	Electric services
4920	Gas production and distribution
4930	Combination utility services
4990	Water supply and other sanitary services

WHOLESALE TRADE

Durable goods:

5008	Machinery, equipment, and supplies
5010	Motor vehicles and automotive equipment
5020	Furniture and home furnishings
5030	Lumber and construction materials
5040	Sporting, recreational, photographic, hobby goods, toys, and supplies
5050	Metals and minerals, except petroleum and scrap
5060	Electrical goods
5070	Hardware, plumbing and heating equipment
5080	Machinery, equipment, and supplies
5098	Other durable goods

Nondurable goods:

5110	Paper and paper products
5129	Drugs, drug proprietaries, and druggists' sundries
5130	Apparel, piece goods, and notions
5140	Groceries and related products
5147	Meats and meat products
5150	Farm-product raw materials
5160	Chemicals and allied products
5170	Petroleum and petroleum products
5180	Alcoholic beverages
5190	Misc. nondurable goods

RETAIL TRADE

Building materials, hardware, garden supply, and mobile home dealers:

5220	Building materials dealers
5251	Hardware stores
5265	Garden supplies and mobile home dealers
5300	General merchandise stores
5410	Grocery stores
5490	Other food stores

Automotive dealers and service stations:

Code	
5515	Motor vehicle dealers
5541	Gasoline service stations
5598	Other automotive dealers
5600	Apparel and accessory stores
5700	Furniture and home furnishing stores
5800	Eating and drinking places

Misc. retail stores:

5912	Drug stores and proprietary stores
5921	Liquor stores
5995	Other misc. retail stores

FINANCE, INSURANCE, AND REAL ESTATE

Banking:

6030	Mutual savings banks
6060	Bank holding companies
6090	Banks, except mutual savings banks and bank holding companies

Credit agencies other than banks:

6120	Savings and loan associations
6140	Personal credit institutions
6150	Business credit institutions
6199	Other credit agencies

Security, commodity brokers, dealers, exchanges, and services:

6210	Security brokers, dealers, and flotation companies
6299	Commodity contracts brokers and dealers; security and commodity exchanges; and allied services

Insurance:

6355	Life insurance
6356	Mutual insurance except life or marine and certain fire or flood insurance companies
6359	Other insurance companies
6411	Insurance agents, brokers, and services

Real estate:

6511	Real estate operators (except developers) and lessors of buildings
6516	Lessors of mining, oil, and similar property
6518	Lessors of railroad property and other real property
6530	Condominium management and cooperative housing associations
6550	Subdividers and developers
6599	Other real estate

Holding and other investment companies:

6742	Regulated investment companies
6743	Real estate investment trusts
6744	Small business investment companies
6749	Holding and other investment companies except bank holding companies

SERVICES

7000	Hotels and other lodging places
7200	Personal services

Business services:

7310	Advertising
7389	Business services except advertising

Auto repair and services; misc. repair services:

7500	Auto repair and services
7600	Misc. repair services

Amusement and recreational services:

7812	Motion picture production, distribution, and services
7830	Motion picture theaters
7900	Amusement and recreation services, except motion pictures

Other services:

8015	Offices of physicians, including osteopathic physicians
8021	Offices of dentists
8040	Offices of other health practitioners
8050	Nursing and personal care facilities
8060	Hospitals
8071	Medical laboratories
8099	Other medical services
8111	Legal services
8200	Educational services
8300	Social services
8600	Membership organizations
8911	Architectural and engineering services
8930	Accounting, auditing and bookkeeping
8980	Miscellaneous services (including veterinarians)

OTHER

9000	Unrelated debt-financed activities other than rental of real estate
9100	Investment activities by section 501(c)(7), (9), (17), or (20) organizations
9200	Rental of personal property
9300	Passive income activities with controlled organizations
9400	Exploited exempt activities

Chairman **Pickle**. Thank you very much. You have just finished saying that your report shows that you have at least advised IRS that they could greatly improve their examination selection process. Explain that more in detail, for me. Where has been the weakness in their procedure, and by example, how would they do a much better case if they had a stronger selection process?

Ms. **Stathis**. They have been selecting forms 990 for examination; and they have been doing that on the basis of a formula, computed from periodic taxpayer compliance measurement programs, to identify problems with 990 reporting. They had never factored into those formulas anything specifically dealing with the 990-T, the unrelated business income tax. Those particular forms were just examined as part of the 990 examination so, in other words, there was no targeting of the 990-T forms. We suggested in that 1985 report, that they could do a better job targeting returns by including in the taxpayer compliance measurement program some information on the 990-T's so that they could identify the most noncompliant 990-T's.

Chairman **Pickle**. How do we improve the situation if we change the 990 or the 990-T to get more information and, at the same time, make it more complex, more technical, more difficult to fill out? You just said that some of the smaller organizations may have difficulty in completing the form. Now, if we get the information we want, we are also going to be making it more difficult for a lot of other organizations, will we not?

Ms. **Stathis**. I am not sure what you are referring to. What we are asking IRS to do is not to change the 990-T but just to systematically collect more information organizations that have not complied.

Chairman **Pickle**. Wouldn't that be shown on the 990?

Ms. **Stathis**. On the 990——

Chairman **Pickle**. T.

Ms. **Stathis**. On the 990-T. Yes. In other words, IRS has all of the information we are asking them to use. We are just asking them to analyze it to identify the most noncompliant organizations or those that would potentially be the most noncompliant so that you can better target your examination resources.

Chairman **Pickle**. Well, apparently, the IRS is going to follow that recommendation and they are setting in process that study and implementation within the next 4 months so perhaps that will be a definite improvement. In the area of unfair competition, what specific industries feel that they have been the victim of exempt organizations by virtue of competition?

Ms. **Stathis**. The six industries that we examined, and I might point out that we got to these six industries from the data that Mr. Swain has. We went to his office and looked at the letters of complaint that the Small Business Administration had received. We analyzed all of those letters of complaint, and concluded that the six industries that we have in this report, were the ones who had complained the most about competition.

Chairman **Pickle**. All right and what are they?

Ms. **Stathis**. That is the audiovisual, racquet sport

Chairman **Pickle**. Wait just a minute. Audio-visual—all right.

Ms. STATHIS. Racquet sports, research and testing, tour business, and travel agents, and we separated those two out because their complaints seemed to be different, and then veterinarians.

Chairman PICKLE. Secretarial?

Ms. STATHIS. Veterinarians.

Chairman PICKLE. Veterinarians. All right. Well, thank you. What exempt organizations are engaging in commercial activities that might constitute unfair competition? Can you answer that in a broad sense?

Ms. STATHIS. I really do not think that I have an answer for that. We did not attempt to even define what unfair competition is. We looked at those six types of businesses that I mentioned to you, and we surveyed members of those industries and asked them whether they had competition from tax exempt organizations.

Chairman PICKLE. One of the questions that was constantly before the panel that preceded you, was this question of the two court cases that resulted in almost half the revenue this past year. Your statement says that the main issue in those two cases was acquisition indebtedness resulting from a real estate transaction. Now, my question to them was whether there are a lot of cases like that out there that would be similarly brought to a head if somebody went to court? Or is that just a rare exception? They said they had no idea. Do you have any idea whether it is a rare case?

Ms. STATHIS. I have no more information than they do, Mr. Chairman.

Chairman PICKLE. Can you identify those types of cases if not by company then by type of cases other than real estate transactions?

Ms. STATHIS. No. What we have in the statement is as much as we are able to report publicly on that.

Chairman PICKLE. What you state here is all you can state?

Ms. STATHIS. That is correct.

Chairman PICKLE. Well, we will be interested in trying to get additional information on that. Mr. Rangel is not available at this moment. Mr. Frenzel, did you have another question?

Mr. FRENZEL. Mr. Chairman, I did not. I wanted to thank the witness for her testimony and the office and I assume we will be contacting them.

Chairman PICKLE. Well, I thank you very much. Your testimony is helpful. GAO, we say to you, we are glad you actually ran the survey and we are going to watch with interest the suggestion you made that IRS may or may not carry out. SBA, I would wish you would give me some specific example of unfair competition so that we may have an idea, more exactly, what businesses are being affected. I am glad to have these six fields kind of narrowed down to the six main types, but we want to know practically, how are they being hurt and how can we change it. So we thank you both for your testimony very much.

[Recess.]

Chairman PICKLE. The chairman asks the committee to come to order. It seems that when we lost the IRS, Treasury and GAO groups, our crowd dwindled, Mr. Frenzel. And if you have been listening to this testimony and are leaving, we ask that you leave quietly. If somebody would please check the door over there. The next panel will consist of the Independent Sector, Marion R. Fremont-

Smith; the Business Coalition for Fair Competition, Joseph O'Neil; the National Assembly of National Voluntary Health and Social Welfare Organizations, Sheldon Cohen; the National Federation of Independent Business, John Motley; the Nonprofit Coordinating Committee, Peter Swords; and the U.S. Chamber of Commerce, Dr. Earl Hess. We will start off on the order that they are listed on the schedule. The first witness will be Ms. Marion Fremont-Smith, board member, representing the Independent Sector. And then we will go to Mr. O'Neil, Sheldon Cohen, Mr. Motley, Mr. Swords, and Dr. Hess. Ms. Smith, will you proceed?

STATEMENT OF MARION R. FREMONT-SMITH, BOARD MEMBER, INDEPENDENT SECTOR

Mrs. **Fremont-Smith.** Mr. Chairman. I am Marion Fremont-Smith of Boston. I am a member of the law firm of Choate, Hall & Stewart, at which I have practiced in the area of tax exempt organizations and their problems for more than 25 years.

Independent Sector is a membership organization representing 650 national tax-exempt organizations, foundations, and corporations. The organizations which are members, in turn, represent the vast majority of the exempt charitable organizations in the country. We have prepared a statement for the record that I commend to your attention particularly the statistics that Independent Sector and the Urban Institute have compiled on the recent growth of the sector and its sources of support.

We welcome the committee's decision to review the issue of competition between exempt organizations and their for-profit counterparts, and the effectiveness of the unrelated business income tax provisions adopted after a series of congressional hearings held nearly 40 years, at which the complaints from the business community were not different from those now voiced.

We agree with the Treasury that the rules adopted then provide a sound framework for distinguishing between those activities of the nonprofit organizations which should be tax free and those which should be subject to tax. We recognize that there are far more exempt organizations today and that they conduct a wide variety of activities. It would be foolish to say that no specific changes are warranted. We are concerned, however, that Congress may be pushed to adopt changes in the code without considering fully their impact. This is because, as pointed out by all of your earlier speakers and despite the length of time since this law was enacted, we really do not have the information necessary to tell us how effective it is.

Any changes in the law, should be based on more than anecdote. Accordingly, Independent Sector is recommending some specific steps that we believe that your committee could support to improve the information that we receive. The new audit programs adopted by the service are very important first steps. However, a very simple action would be to computerize and provide to the public the detailed information that comprises page 1 of form 990. We only know gross assets of exempt organizations. We only have numbers on gross revenue. What we need is the sources of the assets, the sources of revenue, and the details of expenses. Until we have that information, we are really not in a position to say what additional questions, if any, should be asked.

In addition to the Internal Revenue Service, however, the 1990 U.S. Census is another source of information which could be of great value. We would hope—and with your support we believe that the people who are compiling the questionnaires for that census will comply—that they would differentiate nonprofits and for-profits as employees and as employers. We would like to see this distinction made in the Service Industry Index and in the county business practices survey. This could give us a much broader picture of the independent sector and will provide answers to many of the questions you have been asking that none of us seem to be able to answer.

We urge, therefore, that you adopt, in a sense, a two-level process. First, that you recommend steps to improve the data on exempt organization activities so that we can know what we are dealing with. Then if you decide that specific legislation is required, you afford all interested parties a chance to discuss the specific legislative recommendations that will affect them.

There is a very intricate balance among the business sector, Government, and the independent sector. We recognize that it is not an easy one to maintain. As you consider changes that may be needed, we hope, that you will recognize the important contributions of the independent sector to our society. Thank you.

[The statement of Marion R. Fremont-Smith, and letters received subsequent to the hearing, follow:]

STATEMENT OF MARION R. FREMONT-SMITH
BOARD MEMBER, INDEPENDENT SECTOR

I. INTRODUCTION

I am Marion R. Fremont-Smith, a partner in the Boston law firm of Choate, Hall & Stewart specializing in the law of tax-exempt organizations, and a Board Member of INDEPENDENT SECTOR. INDEPENDENT SECTOR is a membership organization of 650 nonprofit organizations, foundations, and business corporations. These organizations in turn represent the vast majority of approximately 350,000 501(c)(3) organizations in this country. This diverse membership has banded together to strengthen our national tradition of giving, volunteering and not-for-profit initiative. A list of our members is attached (see Attachment 1).

Notice of the Subcommittee on Oversight's inquiry into the activities of nonprofit organizations, the use of unrelated business income tax (UBIT) rules, and the incidence of competition between nonprofit organizations and for-profit businesses, has sparked considerable attention to these matters within the nonprofit community. There is a naive assumption by the U.S. Small Business Administration and some small business trade associations reflected in their report "Unfair Competition by Nonprofit Organizations With Small Business: An Issue for the 1980s" that nonprofit organizations exist only to relieve misery and serve the poor, and that this is the only basis on which tax exemption is granted. This does not accommodate the churches or museums or private universities, or even advocacy or conservation groups.

There is also a belief that if a profit-making organization is available to provide the service, similar services should not also be provided by nonprofit organizations or, if provided, the nonprofit organization should be taxed on any such income. But, does this mean that any neighborhood hospital or day-care center or home for the aged should serve only the poor if there are for-profit counterparts and, if so, doesn't that smack of the old county hospital, which we've struggled so hard to get away from, and which can hardly be put forward as an example of humane care.

And there is a belief that the problem exists because nonprofit organizations are moving into territory traditionally occupied by profit-making groups. But the current situation is more than matched by the number of for-profit organizations moving into territories traditionally occupied by voluntary groups, including hospitals, day-care centers, alcoholism treatment centers, homes for the aged, health research, continuing education and even cemeteries.

To address the issues related to competition between for-profits and not-for-profits, INDEPENDENT SECTOR has organized a Task Force on Competition to increase our understanding of nonprofit activities. In turn, each of the 50 nonprofit Task Force members has, in one way or another, analyzed their own activities in light of concerns about competition and the UBIT rules.

This testimony outlines what we have learned through our work with various nonprofit organizations. It presents a profile of nonprofit organizations, including rationales for the tax exemption, insights into who is served by nonprofit organizations, and information on nonprofit sources of income. Further, the testimony recommends proposals to improve federal data collection on nonprofit organizations.

II. A PROFILE OF NONPROFIT ORGANIZATIONS

A. Rationale for the Tax Exemption

Charities have been recognized as special legal entities for centuries, starting with England's Statute of Charitable Uses in 1601 which granted recognition to a broad array of "pious causes," and continuing in this country under the laws of the original 13 colonies and later with the adoption of the first federal income tax in 1913. The unique nature of organizations established to provide a public benefit has served as a rationale for federal, state and local tax exemptions. The federal tax exemption is granted under Section 501(c)(3) of the Internal Revenue Code for a range of public purposes including those carried on by "religious, educational, charitable, scientific, and literary organizations and those testing for public safety, fostering certain national and international sports competitions or prevention of cruelty to children and animals." Thus, contrary to a popular misconception, the tax exemption is not granted exclusively for service to low-income people, but for much broader purposes as well.

The legislative history states that "the exemption from taxation of money or property devoted to charitable and other purposes is based on the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds and by the benefits resulting from the promotion of the general welfare." H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938). This statement acknowledges the historic partnership between government and nonprofit organizations to provide for the general welfare. Current concerns about competition call into question the role played by each sector -- nonprofit, government and business -- in promoting the general welfare.

Partnership with government is important to an understanding of the nonprofit community, but its social role extends far beyond that partnership. The nonprofit sector offers a rich tradition of nongovernmental citizen participation. This tradition forms a backdrop to some fundamental differences between nonprofit organizations and for-profit businesses. A number of those important differences are described below:

> First, the nonprofit community is a place where the great diversity of individual aspirations become part of the public process. Our pluralistic traditions are manifest in nonprofit activity through community participation and empowerment. Often, unifying themes arise from the coming together of people from all walks of life to address common problems. Equally important is the forum provided by independent institutions for nonmajoritarian impulses. For-profits are intended to serve primarily an economic function guided by market forces, not a social purpose motivated by the principles of pluralism.
>
> Second, the purpose of a nonprofit organization is to promote the public good. This purpose may be fulfilled through an assortment of activities, including education; conservation; conducting or promoting cultural, religious, or scientific activities; providing those in need with food, clothing, or shelter; fostering self-help; and advocating changes in public policy on behalf of an issue or underserved population. A business that carries out one or more of these activities might also serve the public good, but its principal purpose is to make a profit. This distinction is recognized by the U.S. Treasury which has stated that, "an organization is not organized and operated exclusively for one or more of the

purposes specified in Section 501(c)(3) unless it serves a public rather than a private interest." (emphasis added) Treasury Regulation Section 1.501(c)(3)-1(d)(1)(ii).

Third, no private individual has any profit or ownership interest in a nonprofit organization. Ultimately all private businesses, however public spirited, are run to produce a profit for their owners. By contrast, if a nonprofit has excess revenue over expenses -- a relatively rare occurrence -- the surplus must be reserved and used for the charitable purpose of the organization, e.g., to cover deficits in later years or to subsidize free or low-cost services to those unable to pay the full cost. A for-profit distributes its excess revenue over expenses to owners as profits; a nonprofit is specifically prohibited from doing this.

Fourth, a for-profit will, over the long run, only provide services that make a profit. Nonprofit organizations can continue to provide services even when it is not economically advantageous to do so, either because they receive charitable contributions or because they are prepared to operate on a long term break-even basis, a situation which would not be tolerable for private investors.

Fifth, nonprofit organizations benefit from charitable contributions of money and volunteer time as a reflection of the community support for the public benefits provided by the nonprofit. Community support for a for-profit is expressed through buying of goods and services or purchasing stock.

Sixth, nonprofit organizations are accountable to the public through regulations enforced by the state attorneys general, and through public scrutiny and IRS supervision of their tax returns. Many are also governed by community boards. A for-profit business, although subject to various specific government regulations, is not generally accountable to either government or the community, but rather to its shareholders.

Finally, the services of nonprofit organizations must be available to a broad cross-section of the community. General accessibility to nonprofit services is guaranteed by the IRS auditing program which requires charitable benefits flow to "a significant segment of the community." In Re Henderson's Estate, 112 P.2d 605, 609 (Cal. 1941). The availability of for-profit goods and services, on the other hand, is based on ability to pay.

B. Sources of Income

Research by INDEPENDENT SECTOR and the Urban Institute on sources of support for the independent sector (e.g., those organizations defined in sections in 501(c)(3) and 501(c)(4) of the federal tax code as tax-exempt organizations) is useful to the Subcommittee's inquiry into the nature of and trends in income-producing activities. General comparisons between nonprofit organizations and businesses can be made using our research; however, analyzing specific activities carried on by both nonprofits and for-profits requires improved federal data collection. Proposals to improve federal data collection are addressed later.

The data we have collected show that since 1977 no major shifts in sources of support have occurred across the entire sector. However, where certain areas of the independent sector experienced significant federal budget cuts, the evidence indicates that some increase in fees for service occurred. Attachment No. 2 provides an overview of sources and disposition of annual funds by subsector of the independent sector. It is not surprising that our analysis shows some correlation between relative decreases in government support and pressures to increase other sources of support.

Our research shows a relative decline in third-party support consisting of private contributions and government participation, and a relative rise in both direct payments and fees for service and in investment and other types of income. Between 1977 and 1983, third-party support fell from 56.3 percent to 53.1 percent, but recovered in 1984 to 53.8 percent, mainly because of an increase in private contributions. Some of the improvement can be attributed to the charitable deduction for nonitemizers.

Government support which had increased from almost 27 percent in 1977 to almost 28 percent in 1980 remained at about 27 percent for 1982 through 1984. Budget increases in the area of health services through Medicare and Medicaid programs had the effect of balancing significant percentage drops in other subsectors. Estimates for direct "payments for service" indicate a rise from 36.4 percent in 1977 to 38.2 percent in 1982 and a slight drop in 1984 to 37.8 percent. Major sources of support for all nonprofit organizations have remained fairly stable from 1977 to 1984. The remaining sources of funds for organizations in the independent sector are endowment income, net income from sales, and gains from sales of assets other than inventory. Estimates of net income from sales and gains from sales of assets other than inventory averaged just under three percent in the category "Other" for the years displayed in Table 1.

Table 1

INDEPENDENT SECTOR: Annual Sources of Funds

Sources	1977 $ billions	1977 %	1982 $ billions	1982 %	1984 $ billions	1984 %
Private Sector:	$83.8	73.3%	$155.3	73.0%	$185.3	73.1%
Contributions	33.8	29.6	55.8	26.2	68.3	26.9
Dues, Fees, etc.	41.6	36.4	80.6	37.9	95.7	37.8
Other Receipts	8.4	7.3	18.9	8.9	21.3	8.4
Endowment	5.3	4.6	12.6	5.9	14.0	5.5
Other	3.1	2.7	6.3	3.0	7.3	2.9
Government	30.5	26.7	57.4	27.0	68.2	26.9
TOTAL	114.3	100.0	$212.7	100.0	$253.5	100.0

Source: Dimensions of the Independent Sector (1986).

Employment, wages and salaries, and proportion of national income are important economic indicator of the independent sector in relation to other sectors. With respect to employment, even when the full-time equivalent of volunteer hours, which represent about 40 percent of the manpower in the independent sector, is included in nonprofit employment figures, research shows that nonprofit employment has begun to shrink in relative terms. From

1977 to 1982, total employment in the independent sector grew faster than employment in business or government, increasing the sector's share of total employment from 8.6 to 9.7 percent. From 1982 to 1984, however, employment in the independent sector grew at a slower rate than business, and the sector's share of total employment declined from 9.7 to 9.5 percent. Although the inadequacies of federal data do not permit employment comparisons activity by activity, we do know that, in the aggregate, the independent sector is losing ground on, not overpowering, other sectors. Table 2 compares annual rates of change between employment in the independent sector and total U. S. employment.

Table 2

ANNUAL RATE OF CHANGE IN EMPLOYMENT
1972-1984

	1972-1982	1982-1984
Total U.S. Employment (Non-Agricultural)	2.0	2.7
Total Independent Sector Employment	3.7	1.0

Source: Dimensions of the Independent Sector (1986).

Typically, average wages and salaries in the independent sector are lower than those in other sectors of the economy, but between 1977 and 1984 average wages and salaries in the independent sector further declined in relation to those in all other sectors. In 1977, wages and salaries in the independent sector were 27 percent lower than the average for all employees, excluding employees in other tax-exempt organizations. By 1984, wages and salaries in the independent sector fell to 29 percent below the average for all employees. Average wages and salaries increased 60 percent in the independent sector from 1977 to 1984, compared with a 63 percent increase for average salaries in other sectors of the economy. Lower wages and salaries in the independent sector manifest the personal sacrifice many make to serve diverse community needs, and distinguish nonprofit from for-profit service providers.

These trends in employment, wages and salaries parallel changes in the independent sector's proportion of national income. The independent sector grew faster than other sectors of the economy from 1977 to 1982, increasing its proportion of national income from 5.2 percent to 5.8 percent during this period. Between 1982 and 1984, this trend was reversed. The independent sector grew more slowly than business and at about the same rate as government; accordingly, its proportion of national income dropped to 5.6 percent ($176.3 billion) in 1984. Table 3 provides a sector-by-sector comparison of national income.

Table 3

NATIONAL INCOME (in billions),
INCLUDING ASSIGNED VALUES FOR VOLUNTEERS AND
UNPAID FAMILY WORKERS, BY THE THREE MAJOR SECTORS
1977, 1982 and 1984

	1977	1982	1984
	$1,637	$2,674	$3,144
Breakdown by Sector			
Private, Nonprofit	5.7%	6.5%	6.2%
Independent Sector	5.2	5.8	5.6
Other	0.6	0.6	0.6
Business	79.4	79.8	79.3
Government	14.9	15.0	14.5
TOTAL	100.0%	100.0%	100.0%

Source: Dimensions of the Independent Sector (1986).

There has been some increase in fees for service in areas hit particularly hard by federal budget cuts and by a contemporaneous fiscal slowdown. Private payments as a proportion of total revenues of education and research organizations increased from 52.9 percent to 53.4 percent from 1977 to 1984, while government support declined from 18.2 percent to 17.0 percent. This trend is even more evident in social services where private payments, primarily fees for service, increased from 9.6 percent of total annual funds in 1977 to 12.6 percent in 1984. At the same time, government payments to the social services declined from 54 percent of total annual funds in 1977 to 44 percent in 1984. The Urban Institute studies suggest that services to clients were reduced as a result of those federal budget cuts.

Research by INDEPENDENT SECTOR and the Urban Institute demonstrates a clear relationship between government policies regarding support for the services rendered by the independent sector and the level of services provided.

C. Who is Served by Nonprofit Organizations?

A misconception we sometimes hear is that nonprofit organizations exist to serve low-income people. It is true that we serve low-income people, but that is only a part of what we do. The nonprofit community serves all kinds of people in a variety of ways. We carry out our mission of promoting the general welfare through a universe of activities with a scope as broad as human needs.

Serious consequences would arise if nonprofit organizations are restricted in any degree to serving only low-income people. Under such circumstances, the creation of a two-tier system of service becomes a possibility -- an inferior level of service for low- and moderate-income people, and a high quality level of service for those who can afford it. Common notions of fairness dictate that such consequences should be avoided. Limiting nonprofit service to low-income people would undermine its pluralistic vitality, destroy its current mix of service recipients, and greatly reduce its degree of financial independence from government. An evaluation of sources of funds to finance the independent sector shows that the tenuous balance between current sources of funds requires continued support from all areas.

The notion that nonprofit organizations serve a wide cross-section of the community has been substantiated by the research of the Nonprofit Sector Project at the Urban Institute. The research results show that nonprofit service recipients come from all income classes, and suggest that the great bulk of those served represent a middle- and lower-middle income constituency. Serving low-income individuals is an important part of the nonprofit mission; however, nonprofit organizations do not exclusively or primarily serve low-income people. The Nonprofit Sector Project found that less than 30 percent of the human service organizations it studied serve a client mix in which low-income people are a majority. Further, about half of the agencies reported that low-income people comprise less than 10 percent of their clients.

Just as the services of human service organizations are not limited to a particular income class, other subsectors of the independent sector carry on activities which enhance the general welfare. The benefits of nonprofit hospital care are not specific to any income group, nor are the benefits of education, scientific research, arts and culture, conservation, public safety, community health, self-help and public advocacy.

The financing necessary to sustain the broad services of the nonprofit community follows, in part, from the fact that we serve people from all income categories. To mention just a few examples, contributions from individuals to colleges and universities are often used to finance scholarship programs for those students who cannot afford the full cost of tuition. Likewise, fees for service in most human service agencies are often arranged on the basis of one's ability to pay. The fees paid by service recipients at the upper end of the income scale often help subsidize free or low-cost services to those who cannot pay the full cost. Further, many people become more sensitive to the needs of others through their involvement in a nonprofit organization and, consequently, contribute time and money to one or more areas of nonprofit service.

III. PROPOSALS TO IMPROVE FEDERAL DATA COLLECTION

Sound quantitative analysis would allow the Subcommittee on Oversight to more clearly determine the relationship between the nonprofit community and the business community. We request the Subcommittee to support recommendations described below to improve federal data collection on nonprofit organizations.

No government agency has full responsibility for gathering or reporting statistics on the independent sector. The only agency of government that has a potential data base on nonprofit organizations is the Internal Revenue Service (IRS), which collects Forms 990 from tax-exempt organizations with revenues of $25,000 or more on an annual basis. However, neither the IRS nor the Statistics of Income Division is mandated to report on tax-exempt organizations, although the IRS must provide Form 990 on request. In the field of charitable organizations, the Statistics of Income Division is only mandated to produce reports on the administrative expenses of foundations.

It is very clear that improved federal data collection is required to identify better the activities of the independent sector. Improving the IRS's accuracy of reporting the information on the Forms 990 for charitable organizations is consonant with increasing the accuracy of forms filed by those organizations. Not until the IRS is able to specify areas where information filed by charitable organizations is deficient will the community be able to take coordinated steps to improve that information. This data problem could be solved by computerizing and reporting the entire first page of the Treasury Form 990 for exempt organizations and the Form 990-PF for private foundations. Publishing these tax forms would provide detailed financial information on nonprofit organizations and private foundations that is currently unavailable. Without knowing the sources of revenues and expenditures, it is difficult to respond with certainty to such public policy issues as competition between nonprofit organizations and small businesses.

A number of states are doing an excellent job of reporting on charitable activities. Four states -- New York, California, New Jersey and Minnesota -- have computerized the complete 990 tax-exempt forms. Partial computerization of Form 990 has been completed in Illinois, Indiana, Maryland, Nevada, New Hampshire, Pennsylvania and Tennessee. Partial or full computerization of the forms is in progress in Massachusetts, Virginia and Connecticut. Presently, the Department of the Treasury has neither the mandate nor the budget to report the information on the Form 990 for all nonprofit organizations.

Even with a system to improve the reporting of information on nonprofits only two numbers would be available -- total assets and total revenues. The problem with the total revenue figure is that it includes "double counting." For example, support from federated fund-raising agencies are added twice -- through the initial collector of funds like the United Way, and from the organizations that receive the funds, like the Girl Scouts. For this reason, the 990 Master File remains unusable. The only way to solve this problem would be to report out the whole first page of the Form 990 which summarizes total assets by source, total revenues by source, and total expenditures by source.

We also recommend inclusion of questions on nonprofit employment and voluntary activity in the decennial Census of the United States. The cost of these questions is insignificant, and they would add considerably to our comparative knowledge about employment in the independent and business sectors.

In the first draft of 1990 Census of the United States, the United States Bureau of the Census for the first time added to its industry/occupation areas a category for an "employee of not-for-profit, tax-exempt, or charitable organization." The current draft of the 1990 Census referred to as the "dress rehearsal questionnaire" by its authors, includes the charitable employment designation. This question is crucial to understanding the status of nonprofit employment vis-a-vis employment in other sectors of society. We urge the Subcommittee to support incorporation of the charitable employment question in the 1990 Census.

The volunteer component of nonprofit employment is crucial to employment comparisons between the independent sector and other sectors. It is estimated that volunteers provide over 40 percent of the total employment in nonprofit, charitable organizations. However, only rarely has the government collected information from the American population on the amount and type of volunteer activities they engage in. On the first draft of the 1990 Census there was a question on volunteer activity and time; however, it has been dropped from the current "dress rehearsal" draft. Your support is needed to reintroduce the question on volunteer activity into the 1990 Census.

The United States Bureau of the Census is mandated to collect a Census of Service Industries every five years. The first Census of Service Industries that included a breakdown between for-profit and nonprofit service organizations was conducted in 1977. However, in 1982, hospitals and higher education which together account for almost 70 percent of the nonprofit sector were excluded from the census. For the benefit of accurate analysis on the nonprofit and for-profit service industries, it is essential that the distinction between for-profit and nonprofit organizations be maintained, and the service industry universe used in the 1977 Census be reintroduced in future Censuses of Service Industries.

Potentially, more current data on the number of establishments, employment and payrolls than that obtained every five years for tax-exempt organizations from the Census of Service Industries could be acquired annually from county Business Patterns, an ongoing program of the Bureau of the Census.

The statistics generated from County Business Patterns become increasingly important for the nonprofit sector since beginning January 1, 1984, all nonprofit organizations were required to belong to the social security system (FICA). Even though religious organizations continue under the elective provision of FICA, for those religious organizations that do participate in the system, the number of establishments, employment, and payrolls are available and included in County Business Patterns. The inclusion of tax-exempt status on the organization records for County Business Patterns could be provided from lists compiled by the Department of the Treasury, the Bureau of the Census, and the Social Security Administration. If such information were lacking for an organization, a simple inquiry about its tax-exempt status would produce the required information. This information would allow for detailed comparisons between nonprofit organizations and for-profit businesses.

Better data are essential to understanding the evolution of the independent sector and its relationship to the small business community. Good numbers will allow us to determine what nonprofit and for-profit service providers are doing, and will help decide what they should be doing. Further, better data will facilitate a process which separates the fact from the anecdote.

The tax-exempt community can contribute to the improvement of federal data collection by submitting to further disclosure requirements which, if drafted in a sensitive manner, should not unduly burden the administration of nonprofit organizations.

V. CONCLUSION

Intricate interrelationships exist between the service roles of the three sectors of American society. As these roles evolve, strains are often created between government, the independent sector, and the business sector. Despite these strains, INDEPENDENT SECTOR sees no need to alter radically the law of tax-exempt organizations. The UBIT rules have served as a sound standard for separating exempt income from taxable income, and they should remain intact.

INDEPENDENT SECTOR proposes improved federal data collection to further identify activities of the independent sector. These steps would allow the Subcommittee to make any necessary adjustments to the law of tax-exempt organizations based on quantitative analysis rather than anecdote.

Should the Subcommittee on Oversight determine that some additional reporting requirements, improved federal data collection, or other legislative changes are necessary, INDEPENDENT SECTOR urges an open public process to allow for full review of any proposals. We have been invited to testify before a balanced inquiry into UBIT rules and competition concerns with no legislative agenda. Therefore, if a legislative agenda is created as a result of these hearings, the interested public should be given the opportunity to respond in a second set of hearings. INDEPENDENT SECTOR offers its full cooperation to any open review process which continues after the hearings have been completed.

Attachment No. 1

List of INDEPENDENT SECTOR Members

IS VOTING MEMBERS

A Presidential Classroom for Young Americans
AAFRC Trust for Philanthropy
ACCESS: Networking in the Public Interest
ACCION International/AITEC
ALS Association
AMVETS National Service Foundation
ARCO Foundation
ARROW
ASPIRA of America
AT&T Foundation
Accountants for the Public Interest
Aetna Life and Casualty Company
Affiliated Leadership League of and For the Blind of America
African Wildlife Foundation, Inc.
Aga Khan Foundation U.S.A.
Aid Association for Lutherans
Aid to Artisans, Inc.
Alcoa Foundation
Alliance of Independent Colleges of Art
Allied Corporation
Allstate Foundation
American Arts Alliance
American Assembly
American Association for Higher Education
American Association for Museum Volunteers
American Association for the Advancement of Science
American Association of Community and Junior Colleges
American Association of Fund-Raising Counsel, Inc.
American Association of Homes for the Aging
American Association of Museums
American Association of University Students
American Association of University Women
Primerica Corporation Foundation
American Cancer Society
American Citizens Concerned for Life
American Committee on Africa
American Council for Judaism
American Council for the Arts
American Council of Learned Societies
American Council on Alcoholism
American Council on Education
American Craft Council
American Dance Guild, Inc.
American Diabetes Association, Inc.
American Ditchley Foundation
American Express Foundation
American Farmland Trust
American Fisheries Society
American Foundation for the Blind, Inc.
American Hospital Association
American Humanics, Inc.
American Institute for Cancer Research
American Leadership Forum
American Library Association
American Lung Association

American ORT Federation, Inc.
American Public Radio
American Red Cross
American Social Health Association
American Stock Exchange, Inc.
American Symphony Orchestra League
American Woman's Economic Development Corporation
American-Standard Foundation
Americans for Indian Opportunity
Amfac, Inc.
Amoco Foundation, Inc.
Anschutz Family Foundation
Appalachian Mountain Club
Arca Foundation
Art Museum Association
Arthritis Foundation
Aspen Institute for Humanistic Studies
Association for International Practical Training
Association for Volunteer Administration
Association of American Colleges
Association of American Universities
Association of American University Presses
Association of Art Museum Directors
Association of Black Foundation Executives
Association of Governing Boards of Universities and Colleges
Association of Hispanic Arts Inc.
Association of Independent Conservatories of Music
Association of Jesuit Colleges and Universities
Association of Junior Leagues, Inc.
Association of Professional Vocal Ensembles
Association of Science Technology Centers
Association of Voluntary Action Scholars
Avon Products Foundation, Inc.
B'nai B'rith International
Mary Reynolds Babcock Foundation
Ball Brothers Foundation
BankAmerica Foundation
Bankers Trust Company
Beatrice Companies, Inc.
Bell Atlantic
BellSouth
Benton Foundation
Beverly Foundation
Big Brothers/Big Sisters of America
Bing Fund Corp.
Blandin Foundation
Boeing Company
Borden Foundation
Boston Foundation
Boston Globe Foundation, Inc.
Botwinick-Wolfensohn Foundation
Boy Scouts of America
Boys Clubs of America
Bread for the World Educational Fund, Inc.
Otto Bremer Foundation

Bristol-Myers Fund, Inc.
Brookings Institution
Brother's Brother Foundation
Brown Foundation, Inc.
Brunswick Foundation, Inc.
Burlington Industries Foundation
Burroughs Corporation
Burroughs Wellcome Fund
Edyth Bush Charitable Foundation, Inc.
Business Committee for the Arts, Inc.
CARE
CBS Inc.
CEIP Fund, Inc.
CODEL - Coordination in Development, Inc.
CPC International, Inc.
Cabot Corporation Foundation
California Community Foundation
Call for Action, Inc.
Camp Fire, Inc.
Carnegie Corporation of New York
Carnegie Foundation for the Advancement of Teaching
Carroll Center for the Blind
Carter Hawley Hale Stores, Inc.
Castle & Cooke, Inc.
Catalyst for Women, Inc.
Caterpillar Foundation
Catholic Charities USA
Center for Corporate Public Involvement
Center for Creative Leadership
Center for Creative Management
Center for the Study of the Presidency
Center to Prevent Handgun Violence
Champion International Corporation
Chase Manhattan Bank, N.A.
Chesebrough-Pond's Inc.
Chevron U.S.A., Inc.
Chicago Tribune Foundation
Child Care Action Campaign
Children's Aid International
Christian Church Foundation
Christian Ministries Management Association
Church Women United
Citicorp/Citibank
Citizens' Scholarship Foundation of America
Civic Education Foundation
Edna McConnell Clark Foundation
Cleveland Foundation
Clorox Company Foundation
Close Up Foundation
Coca-Cola Foundation
College Board
Colonial Williamsburg Foundation
Columbia Foundation
Committee for Food and Shelter
Commonwealth Fund

Community Foundation for Southeastern Michigan
Community Foundation of Greater Washington DC
Congressional Award Foundation
Connecticut Mutual Life Insurance Company
Conoco, Inc.
Conservation Fund
Consortium for the Advancement of Private Higher Education
Corning Glass Works Foundation
Coro Foundation
Corporation for Enterprise Development
Council for Advancement and Support of Education
Council for Aid to Education
Council for American Private Education
Council for the Advancement of Citizenship
Council of Better Business Bureaus/ Philanthropic Advisory Service
Council of Independent Colleges
Council of Jewish Federations
Council on Economic Priorities
Council on Foundations
Council on International and Public Affairs
Council on Library Resources, Inc.
Crown-Zellerbach Foundation
Cystic Fibrosis Foundation
Charles A. Dana Foundation, Inc.
Dance/USA
Edwin W. and Catherine M. Davis Foundation
Dayton Hudson Foundation
Deere and Company
Defenders of Wildlife
Denver Foundation
Geraldine R. Dodge Foundation
Dole Foundation for Employment of Persons with Disabilities
Gaylord and Dorothy Donnelley Foundation
William H. Donner Foundation, Inc.
Joseph Drown Foundation
E.I. DuPont de Nemours and Co.
Duke Endowment
Durfee Foundation
Dyson Foundation
Earthwatch
Eastman Kodak Company
Eaton Corporation
Ecolab Inc.
Education Network for Older Adults
Educational Assistance Ltd.
Eisenhower Foundation
Elderworks, Inc.
Emerson Electric Company
Enterprise Foundation
Environmental Fund
Environmental Law Institute
Epilepsy Foundation of America
Equitable Life Assurance Society of the United States
Evangelical Council for Financial Accountability
Exxon Corporation

Maurice Falk Medical Fund
Family Service America
Federated Department Stores, Inc. Foundation
Federation of State Humanities Councils
First Bank System Foundation
Food Research and Action Center
Food for the Hungry, Inc.
Ford Foundation
Ford Motor Company Fund
Foreign Policy Association
Forty Plus Educational Center, Inc.
Foundation Center
Foundation for Children with Learning Disabilities
Foundation for Exceptional Children
Foundation for Teaching Economics
Foundation for the Carolinas
Foundation for the Peoples of the South Pacific, Inc.
Fresh Air Fund
Friends Association for Higher Education
Fuller Foundation
Fund for Artists' Colonies
Fund for New Jersey
Fund for New Jersey
Fund for an OPEN Society
GTE Foundation
Gannett Foundation
General Conference of Seventh-day Adventists
General Electric Company
General Foods Corporation
General Mills Foundation
General Motors Foundation
General Service Foundation
Georgia-Pacific Foundation, Inc.
Wallace Alexander Gerbode Foundation
J. Paul Getty Trust
Giraffe Project
Girl Scouts of the U.S.A.
Girls Clubs of America, Inc.
Morris Goldseker Foundation of Maryland, Inc.
Goodwill Industries of America
Grace Foundation, Inc.
GrandMet USA, Inc.
Grantmakers in Health
Lucile & Robert H. Gries Charity Fund
Grotto Foundation
Grumman Corporation
Gulf + Western Foundation
George Gund Foundation
Alan Guttmacher Institute
Miriam and Peter Haas Fund
Walter and Elise Haas Fund
Evelyn and Walter Haas, Jr. Fund
Habitat for Humanity, Inc.
Hallmark Cards, Inc.
Luke B. Hancock Foundation

James G. Hanes Memorial Fund/ Foundation
Harris Foundation
Hartford Insurance Group Foundation
Hawaiian Foundation
Edward W. Hazen Foundation
Healing Community
William Randolph Hearst Foundation
H.J. Heinz Company Foundation
Heublein Foundation
William and Flora Hewlett Foundation
Hillman Foundation, Inc.
Conrad N. Hilton Foundation
Hispanic Policy Development Project
Hitachi Foundation
Hoffmann-LaRoche Foundation
Hogg Foundation for Mental Health
Honeywell Foundation
Hospital Research and Educational Trust
Hudson Webber Foundation
Hunt Foundation
Huntington's Disease Foundation of America
Godfrey M. Hyams Trust
IBM Corporation
INTERPHIL (International Standing Conference on Philanthropy)
Independent College Funds of America, Inc.
Independent Research Libraries Association
Institute for Journalism Education
Institute for Nonprofit Organization Management
Institute of Current World Affairs
InterAction (American Council for Voluntary International Action)
International Assn. of Psychosocial Rehabilitation Services
International Christian Youth Exchange
The International Exchange Association
International Fund for Animal Welfare
International Paper Company Foundation
International Primate Protection League
International Women's Health Coalition
Interracial Council for Business Opportunity
James Irvine Foundation
Irving Trust Company
Ittleson Foundation
JWB
Japan-America Student Conference, Inc.
Jerome Foundation
Johnson & Johnson
Johnson Foundation, Inc.
Robert Wood Johnson Foundation
Joint Center for Political Studies
Joint Council on Economic Education
Jostens Foundation, Inc.
Joyce Foundation
Junior Achievement Inc.
K Mart Corporation
Henry J. Kaiser Family Foundation
Keep America Beautiful, Inc.

W.K. Kellogg Foundation
John F. Kennedy Center for the Performing Arts
John F. Kennedy Library Foundation
Charles F. Kettering Foundation
Kiplinger Foundation
Knight Foundation
Kraft, Inc.
Kresge Foundation
Samuel H. Kress Foundation
Albert Kunstadter Family Foundation
LAOS, Inc./Partners for Global Justice
League of Women Voters Education Fund
Sara Lee Foundation
Leukemia Society of America, Inc.
Lilly Endowment, Inc.
Eli Lilly and Company
Literacy Volunteers of America
Los Angeles Women's Foundation
Lubrizol Foundation
Henry Luce Foundation
Lutheran Brotherhood Foundation
Lutheran Council in the USA
Lutheran Resources Commission - Washington
Lyndhurst Foundation
MATHCOUNTS Foundation/NSPE Education Foundation
John D. and Catherine T. MacArthur Foundation
Make-A-Wish Foundation of America
March of Dimes Birth Defects Foundation
John and Mary R. Markle Foundation
McAuley Housing Foundation
Robert R. McCormick Charitable Trust
McGraw-Hill Foundation
McGregor Fund
McKesson Foundation, Inc.
Meadows Foundation
Meals for Millions/Freedom from Hunger Foundation
Medina Foundation
Medtronic Foundation
Richard King Mellon Foundation
Merrill Lynch and Company Foundation, Inc.
Metropolitan Life Foundation
Mexican American Legal Defense and Educational Fund
Eugene and Agnes E. Meyer Foundation
John Milton Society for the Blind
Minneapolis Foundation
Mobil Oil Corporation
Monsanto Company
Philip Morris, Inc.
Stewart R. Mott Charitable Trust
Charles Stewart Mott Foundation
Mountain Bell Foundation
Ms. Foundation for Women, Inc.
Mutual Benefit Life
Mutual of America Life Insurance Company
NAACP Legal Defense and Educational Fund

IS VOTING MEMBERS

NOW Legal Defense and Education Fund
NYNEX
National 4-H Council
National Academy of Public Administration
National Action Council for Minorities in Engineering
National Alliance for the Mentally Ill
National Alliance of Business
National Assembly of Local Arts Agencies
National Assembly of Nat'l. Vol. Health and Social Welfare Org. Inc.
National Assembly of State Arts Agencies
National Association for Bilingual Education
National Association for Hispanic Elderly
National Association for Hospital Development
National Association for Visually Handicapped
National Association for the Advancement of Colored People
National Association of College and University Business Officers
National Association of Community Health Centers, Inc.
National Association of Homes for Children
National Association of Independent Colleges and Universities
National Association of Independent Schools
National Assn. of Latino Elected and Appointed Officials (NALEO)
National Association of Private Schools for Exceptional Children
National Association of Public Television Stations
National Association of Schools of Art and Design
National Association of Schools of Music
National Association of Schools of Public Affairs and Administration
National Association of United Methodist Foundations
National Association on Drug Abuse Problems, Inc.
National Audubon Society
National Bureau of Economic Research
National Catholic Development Conference, Inc.
National Center for Urban Ethnic Affairs
National Charities Information Bureau, Inc.
National Child Labor Committee, Inc.
National Committee For Adoption, Inc.
National Committee for Citizens in Education
National Committee for the Prevention of Child Abuse
National Concilio of America
National Congress for Community Economic Development
National Congress of Parents and Teachers
National Consumers League, Inc.
National Corporate Fund for Dance, Inc.
National Corporate Theatre Fund
National Council for International Visitors
National Council for Research on Women
National Council of La Raza
National Council of Senior Citizens
National Council of Women of the United States
National Council of the Churches of Christ in the USA
National Council on Alcoholism, Inc .
National Down Syndrome Society
National Easter Seal Society, Inc.
National Education Association
National Executive Service Corps
National FFA Foundation

National Family Planning and Reproductive Health Association
National Federation of Business and Professional Women's Clubs, Inc.
National Fish and Wildlife Foundation
National Foundation for Long Term Health Care
National Fund for Medical Education
National Future Homemakers of America
National Gardening Association, Inc.
National Headache Foundation
National Health Council
National Hispanic Scholarship Fund
National Home Library Foundation
National Hospice Organization
National Image, Inc.
National Indian Youth Council
National Institute for Dispute Resolution
National Job Corps Alumni Association, Inc.
National Medical Enterprises, Inc.
National Medical Fellowships, Inc.
National Mental Health Association
National Multiple Sclerosis Society
National Municipal League/Citizens Forum on Self-Government
National Neighborhood Coalition
National Neighbors, Inc.
National Network of Grantmakers
National Network of Runaway and Youth Services, Inc.
National Park Foundation
National Parks and Conservation Association
National Peace Institute Foundation
National Press Foundation, Inc.
National Psoriasis Foundation
National Public Radio
National Puerto Rican Coalition, Inc.
National Puerto Rican Forum, Inc.
National Retiree Volunteer Center
National School Volunteer Program, Inc.
National Society for Children and Adults with Autism
National Society of Fund Raising Executives
National Society to Prevent Blindness
National Sudden Infant Death Syndrome Foundation, Inc.
National Training and Information Center
National Trust for Historic Preservation
National Urban Coalition
National Urban Fellows, Inc.
National Urban League
National Wildlife Federation
Native American Rights Fund
Nature Conservancy
New Haven Foundation
New World Foundation
New York Community Trust
New York Life Foundation
New York Times Company Foundation, Inc.
Nordson Foundation
Northwest Area Foundation
Northwestern National Life Insurance Company

Jessie Smith Noyes Foundation
OICs of America, Inc.
OPERA America
Oakleaf Foundation
Older Women's League
Open Space Institute
Organization of Chinese American Women
Outward Bound, Inc.
Owens-Illinois, Inc.
PPG Industries, Inc.
Pacific Telesis Group
David and Lucile Packard Foundation
Palm Beach County Community Foundation
Parents Anonymous
J.C. Penney Company, Inc.
People for the American Way
Permanent Charities Committee of the Entertainment Industries
Pew Charitable Trusts
Pfizer Foundation, Inc.
Phillips Petroleum Foundation, Inc.
Pillsbury Company Foundation
Piton Foundation
Pittsburgh Foundation
Planetary Society
Planned Parenthood Federation of America
Polaroid Foundation, Inc.
Population Council
Population Crisis Committee/Draper Fund
Population Resource Center
Premier Industrial Foundation
Procter and Gamble Fund
The Progressive Corporation
Prudential Foundation
Public Affairs Council
Public Education Fund
Public Service Satellite Consortium
Puerto Rican Legal Defense and Education Fund, Inc.
Quaker Oats Company
Quest National Center
RJR Nabisco, Inc.
RP Foundation Fighting Blindness
Ray Foundation
Raytheon Company
Reader's Digest Foundation
Reading is Fundamental, Inc.
Recording for the Blind
Reinberger Foundation
Charles H. Revson Foundation
Sid W. Richardson Foundation
Rockefeller Brothers Fund
Rockefeller Family Fund
Rockefeller Foundation
Rockwell International Corporation Trust
Rohm and Haas Company
Rosenberg Foundation

Safeco Insurance Companies
Russell Sage Foundation
Saint Paul Companies, Inc.
Saint Paul Foundation
Salvation Army
San Francisco Foundation
Santa Fe Southern Pacific Foundation
Save the Children
Schering-Plough Corporation
Dr. Scholl Foundation
Scientists' Institute for Public Information
Scott Paper Company Foundation
Seaver Institute
Second Harvest
70001 Training and Employment Institute
Shell Companies Foundation Incorporated
Sherwin-Williams Company
Shubert Foundation
Sierra Club
Sierra Foundation
Lois and Samuel Silberman Fund
Melvin Simon & Associates, Inc.
Skidmore, Owings & Merrill Foundation
Skillman Foundation
Alfred P. Sloan Foundation
John Ben Snow Foundation, Inc.
Southern Education Foundation
Southwestern Bell Foundation
Spencer Foundation
Spring Hill Center
Spunk Fund, Inc.
Standard Oil Company (Ohio)
W. Clement & Jessie V. Stone Foundation
Aaron Straus and Lillie Straus Foundation, Inc.
Levi Strauss Foundation
Student Conservation Association, Inc.
Subaru of America Foundation
Sun Company, Inc.
Support Center
Syntex U.S.A., Inc.
TRW, Inc.
Taconic Foundation, Inc.
Tandy Corporation/Radio Shack
Anne Burnett Tandy and Charles D. Tandy Foundation
Teachers Insurance (TIAA-CREF)
Tektronix Foundation
Telecommunications Cooperative Network
Tenneco Inc.
Texaco Philanthropic Foundation Inc.
Theatre Communications Group, Inc.
3M Company
Time Inc.
Transamerica Corporation
Travelers Aid International
Trilateral Commission

Trust for Public Land
USO World Headquarters
Union Carbide Corporation
Union Pacific Foundation
United Board for Christian Higher Education in Asia
United Jewish Appeal
United Negro College Fund
United States Catholic Conference
United States Steel Foundation
United States-China Educational Institute
United Way of America
Upjohn Company
VOLUNTEER - The National Center
Visiting Nurse Associations of America
Volunteer Trustees of Not-For- Profit Hospitals
Volunteers of America, Inc.
WOMENS WAY
Wain Foundation
Izaak Walton League of America
Warner Communications Inc.
Warner-Lambert Charitable Foundation
Washington Center
Washington Post Company
Weingart Foundation
Wells Fargo Foundation
Westinghouse Electric Corporation
Weyerhaeuser Company Foundation
Weyerhaeuser Family Foundation, Inc.
Mrs. Giles Whiting Foundation
Amherst H. Wilder Foundation
Women and Foundations/Corporate Philanthropy
Women in Community Service, Inc.
Women's Action Alliance, Inc.
Women's Equity Action League (WEAL)
Women's Foundation
Robert W. Woodruff Foundation
Woods Charitable Fund, Inc.
World Resources Institute
World Vision
World Wildlife Fund/The Conservation Foundation
Wyman Youth Trust
Xerox Corporation
YMCA of the USA
YWCA of the USA
Youth for Understanding International Exchange
Zale Corporation
Zellerbach Family Fund

Attachment No. 2

TABLE 4.1
INDEPENDENT SECTOR: SOURCES AND DISPOSITION OF ANNUAL FUNDS BY SUBSECTOR, 1984, 1983, 1982, 1980, AND 1977
(In billions of dollars)

SIC code	Subsector	Annual sources of funds									Disposition		
		Private contributions	Payments			Other receipts							
		Total	Private sector	Government sector	Total	Endowment, investment income	Church	Other	Total	[illegible]	Current operating expenditures[a]	Construction and capital improvements	Other, including change in holding of funds[b]
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	[illegible]	(10)	(11)	(12)
	1984												
80	Health services	$10.4	$60.8	$44.5	$105.3	$ 1.4	$ 7.0	$1.6	$10.0	$125.7	$104.7	$ 8.4	$12.6
82.892	Education/research	8.3	30.5	9.7	40.2	3.3	3.5	1.7	8.6	57.1	48.7	4.2	4.2
866	Religious organizations[c]	35.6	-	-	-	1.3	-10.8	2.7	-6.8	28.8	17.1	1.1	10.6
83	Social services	8.0	2.7	9.4	12.1	0.7	0.2	0.4	1.3	21.4	19.9	0.6	0.9
864	Civic, social, and fraternal organizations	2.1	0.9	3.5	4.4	0.1	0.1	0.3	0.5	7.0	6.7	0.1	0.2
483,792, 84	Arts and culture	4.6	0.7	0.9	1.6	0.2	-	0.5	0.7	6.9	3.4	0.1	3.4
6732	Foundations including international activities[d]	-4.2	3.4	-	3.4	7.0	-	-	7.0	6.2	0.6	-	5.6
81	Legal services	0.1	0.1	0.2	0.3	-	-	-	-	0.4	0.4	-	-
	Total[*]	$68.3	$95.7	$68.2	$163.9	$14.0	0.0	$7.2	$21.3	$253.5	$201.5	$14.5	$37.5
	1983												
80	Health services	$ 9.4	$57.7	$40.4	$ 98.1	$ 1.3	$6.4	$1.5	$ 9.2	$118.7	$ 98.2	$ 8.8	$ 9.7
82.892	Education/research	7.7	27.8	9.0	36.8	2.9	3.2	1.5	7.6	52.1	44.7	3.9	3.5
866	Religious organizations	31.9	-	-	-	1.1	-9.9	2.5	-6.3	25.6	17.1	0.9	7.6
83	Social services	7.2	2.5	9.2	11.7	0.6	0.2	0.4	1.2	20.1	18.4	0.7	1.0
864	Civic, social, and fraternal organizations	1.9	0.8	3.2	4.0	0.1	0.1	0.3	0.5	[illegible]	6.1	0.1	0.2
483,792, 84	Arts and culture	4.2	0.8	0.8	1.4	0.2	-	0.5	0.7	[illegible]	3.0	0.1	3.2
6732	Foundations including international activities	-3.8	3.0	-	3.0	7.3	-	-	7.3	[illegible]	0.6	-	5.9
81	Legal services	0.1	0.1	0.2	0.3	-	-	-	-	0.4	0.4	-	-
	Total[*]	$61.6	$89.5	$62.8	$152.3	$13.5	0.0	$6.7	$20.2	[illegible]	$188.5	$14.5	$31.1
	1982												
80	Health services	$ 8.4	$51.5	$36.5	$ 88.0	$ 1.2	$5.6	$1.6	$ 8.4	[illegible]	$ 88.6	$ 7.7	$ 8.5
82.892	Education/research	7.0	25.3	8.1	33.4	2.8	3.0	1.5	7.3	[illegible]	40.5	3.8	3.4
866	Religious organizations	28.1	-	-	-	1.0	-8.9	2.2	-5.7	[illegible]	16.0	0.8	5.6
83	Social services	6.3	2.3	8.9	11.2	0.5	0.2	0.3	1.0	[illegible]	16.4	0.6	1.5
864	Civic, social, and fraternal organizations	1.7	0.8	2.9	3.7	0.1	0.1	0.2	0.4	[illegible]	5.8	0.1	0.1
483,792, 84	Arts and culture	5.0	0.6	0.8	1.4	0.2	-	0.5	0.7	[illegible]	2.9	0.1	4.1
6732	Foundations including international activities	-3.0	2.2	-	2.2	6.8	-	-	6.8	[illegible]	0.5	-	5.4
81	Legal services	0.1	0.1	0.2	0.3	-	-	-	-	[illegible]	0.4	-	-
	Total[*]	$55.8	$80.6	$57.4	$138.0	$12.6	0.0	$6.3	$18.9	[illegible]	$171.0	$13.1	$26.6
	1980												
80	Health services	$ 6.7	$37.9	$26.1	$ 64.0	$0.9	$4.4	$0.9	$ 6.2	[illegible]	$ 65.1	$ 5.3	$ 6.5
82.892	Education/research	5.7	19.3	7.2	26.5	2.0	2.3	1.1	5.4	[illegible]	32.0	3.0	2.6
866	Religious organizations	22.3	-	-	-	0.8	-6.9	1.7	-4.4	[illegible]	12.9	0.8	4.2
83	Social services	5.0	1.9	8.5	10.4	0.5	0.1	0.3	0.9	[illegible]	13.7	0.4	2.2
864	Civic, social, and fraternal organizations	1.5	0.7	2.7	3.4	0.1	0.1	0.2	0.4	[illegible]	5.1	0.1	0.1
483,792, 84	Arts and culture	3.2	0.5	0.8	1.3	0.2	-	0.3	0.5	[illegible]	2.5	0.1	2.4
6732	Foundations including international activities	-2.6	3.5	-	3.5	3.4	-	-	3.4	[illegible]	0.4	-	3.9
81	Legal services	0.1	-	0.2	0.2	-	-	-	-	[illegible]	0.3	-	-
	Total[*]	$45.4	$60.3	$45.5	$105.8	$7.9	0.0	$4.5	$12.4	[illegible]	$132.0	$ 9.7	$21.9

TABLE 4.1 (continued)

		Annual sources of funds									Disposition		
		Private contributions	Payments			Other receipts				Total funds columns (1)+(4)+(8) or (10)+(11)+(12)			
SIC code	Subsector	Total	Private sector	Government sector	Total	Endowment investment income	Church	Other	Total		Current operating expenditures[a]	Construction and capital improvements	Other including change in holding of funds[b]
	1977												
80	Health services	$ 5.0	$25.2	$16.6	$ 41.8	$0.6	$3.4	$0.5	$4.5	$ 51.3	$43.3	$ 4.4	$ 3.6
82.892	Education/research	4.0	14.5	5.0	19.5	1.5	1.7	0.7	3.9	27.4	23.7	2.1	1.6
866	Religious organizations	17.0	-	-	-	0.6	-5.3	1.3	-3.4	13.6	9.6	0.5	3.5
83	Social services	3.6	1.1	6.1	7.2	0.3	0.1	0.2	0.6	11.4	8.3	0.3	2.8
864	Civic, social, and fraternal organizations	1.2	0.5	2.1	2.6	0.1	0.1	0.2	0.4	4.2	4.0	0.1	0.1
483.792, 84	Arts and culture	2.3	0.3	0.5	0.8	0.2	-	0.2	0.4	3.5	1.6	0.1	1.8
6732	Foundations including international activities	-1.9	2.5	-	2.5	2.0	-	-	2.0	2.8	0.4	-	2.2
81	Legal services	0.1	-	0.2	0.2	-	-	-	-	0.2	0.2	-	-
	Total*	$33.8	$41.6	$30.5	$72.1	$5.3	0.0	$3.1	$8.4	$114.2	$ 91.1	$ 7.5	$15.6

Sources: The figures in this table represent an aggregation of many individual estimates made for specific subsectors from both private and government sources. Private sector contributions are estimated primarily from the American Association of Fund-Raising Counsel, Inc., *Giving USA*, various editions; and the Council for Financial Aid to Education, *Survey of Voluntary Support of Education*, various editions. Private contributions that are based on estimates from *Giving USA* are from the 1985 annual report and therefore differ slightly from those in the 1986 annual report. Tables 3.1, 3.2, and 3.3 incorporate the revised 1986 estimates. For health services and education and research, estimates are prepared largely from statistics published by the American Hospital Association, *Hospital Statistics*, various editions; and the U.S. Department of Education (National Center for Education Statistics), *The Condition of Education*, various editions. For social services; civic, social, and fraternal organizations; arts and culture; and legal services, the estimates for payments from the private and government sectors and other receipts are derived from distribution patterns of revenues for fiscal year 1982 developed by the Salamon et al., *Nonprofit Sector Project, Progress Report No. 3*, The Urban Institute. Basic foundation information is from The Foundation Center, *National Data Book*, and *The Foundation Directory*, various editions; and unpublished data from Internal Revenue Service. Published and unpublished data used to estimate employment, wages and salaries, current operating expenditures, and construction and capital improvement are provided principally by government agencies. Published sources include U.S. Department of Labor (Bureau of Labor Statistics), *Employment and Earnings*, various editions, and *Employment and Wages*, various editions; *Non-Profit Service Organizations: 1982*, as assembled by the National Center for Charitable Statistics. Estimates on religious institutions were derived from Interfaith Research Committee of the Commission on Private Philanthropy and Public Needs, "A Study of Religious Receipts and Expenditures in the United States," *Research Papers*, vol.I, 1977.

Dash = Less than $50 million or no entry is made because it does not apply to this subsector.

SIC = Standard Industrial Classification.

*Totals may not add because of rounding.

[a] Specific estimates for wages and salaries, the major component of operating expenditures, are shown in Tables 4.12, 4.13, 4.14, 4.15, and 4.16.

[b] "Other, including change in holding of funds," is a residual item representing the difference between total funds and the sum of current operating expenditures and capital construction and improvements. This residual item serves to balance the total support and the total disposition of this support for each subsector of the independent sector.

[c] Religious organizations both receive contributions and provide them to other organizations of the independent sector. To present net estimates for the independent sector and to estimate the sacerdotal activities of religious organizations, adjustments are made in the receipts for the religious organization that shows the amount of money subtracted for use on nonsacerdotal activities.

[d] Foundation contributions to the various subsectors of the independent sector are included in the rows in the private contributions column, which is why these contributions show up as a negative estimate for foundations. Estimates placed in the cells for payments from the private sector represent contributions to foundations. Such estimates are not included in column totals for private sector payments but are added to the totals for the private contributions column. Foundations essentially are tax-exempt financial institutions engaged in receiving, investing, and distributing funds to organizations of the independent sector, to government institutions such as public universities, and to individuals. In order to avoid counting both the receipt and the distribution of foundation funds in the overall assessment of the total funds for the independent sector, the net contribution of foundations to the independent sector is estimated by adding contribution of foundations to endowment and subtracting the grants of foundations to the independent sector from total receipts of foundations.

TABLE 4.2
INDEPENDENT SECTOR: SOURCES AND DISPOSITION OF ANNUAL FUNDS BY SUBSECTOR, 1984, 1983, 1982, 1980, AND 1977
(In percent)

		Annual sources of funds									Disposition		
		Private contributions	Payments			Other receipts				Total funds Columns (1)+(4)+(8) or (10)+(11)+(12)			
SIC code	Subsector	Total	Private sector	Government sector	Total	Endowment investment income	Church	Other	Total		Current operating expenditures	Construction and capital improvements	Other including change in holding of funds[b]
	1984	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
80	Health services	8.3%	48.4%	35.4%	83.8%	1.1%	5.6%	1.3%	8.0%	100.0%	83.3%	6.7%	10.0%
82 892	Education/research	14.5	53.4	17.0	70.4	5.8	6.1	3.0	15.1	100.0	85.3	7.4	7.4
866	Religious organizations[c]	123.6	0.0	0.0	0.0	4.5	-37.5	9.4	-23.6	100.0	59.4	3.8	36.8
83	Social services	37.4	12.6	43.9	56.5	3.3	0.9	1.9	6.1	100.0	93.0	2.8	4.2
864	Civic, social, and fraternal organizations	30.0	12.9	50.0	62.9	1.4	1.4	4.3	7.1	100.0	95.7	1.4	2.9
483.792 84	Arts and culture	66.7	10.1	13.0	23.2	2.9	0.0	7.2	10.1	100.0	49.3	1.4	49.3
6732	Foundations including international activities[d]	-67.7	54.8	0.0	54.8	112.9	0.0	0.0	112.9	100.0	9.7	0.0	90.3
81	Legal services	25.0	25.0	50.0	75.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total*	26.9%	37.8%	26.9%	64.7%	5.9%	0.0%	[illegible]	8.4%	100.0%	79.5%	5.7%	14.8%
	1983												
80	Health services	8.1%	49.4%	34.6%	84.1%	1.1%	5.5%	1.3%	7.9%	100.0%	84.1%	7.5%	8.3%
82.892	Education/research	14.8	53.4	17.3	70.6	5.6	6.1	2.9	14.6	100.0	85.8	7.5	6.7
866	Religious organizations	124.6	0.0	0.0	0.0	4.3	-38.7	9.8	-24.6	100.0	66.8	3.5	29.7
83	Social services	35.8	12.4	45.8	58.2	3.0	1.0	2.0	6.0	100.0	91.5	3.5	5.0
864	Civic, social, and fraternal organizations	29.7	12.5	50.0	62.5	1.6	1.6	4.7	7.8	100.0	95.3	1.6	3.1
483.792 84	Arts and culture	66.7	9.5	12.7	22.2	3.2	0.0	7.9	11.1	100.0	47.6	1.6	50.8
6732	Foundations including international activities	-58.5	46.2	0.0	46.2	112.3	0.0	0.0	112.3	100.0	9.2	0.0	90.8
81	Legal services	25.0	25.0	50.0	75.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total*	26.3%	38.2%	26.8%	65.1%	5.8%	0.0%	[illegible]	[illegible]	100.0%	80.5%	[illegible]	13.3%
	1982												
80	Health services	8.0%	49.1%	34.8%	84.0%	1.1%	5.3%	1.5%	8.0%	100.0%	84.5%	7.3%	8.1%
82.892	Education/research	14.7	53.0	17.0	70.0	5.9	6.3	3.1	15.3	100.0	84.9	8.0	7.1
866	Religious organizations	125.4	0.0	0.0	0.0	4.5	-39.7	9.8	-25.4	100.0	71.4	3.6	25.0
83	Social services	34.1	12.4	48.1	60.5	2.7	1.1	1.8	5.4	100.0	88.6	3.2	8.1
864	Civic, social, and fraternal organizations	29.3	13.8	50.0	63.8	2.1	1.7	3.4	6.9	100.0	96.6	1.7	1.7
483.792, 84	Arts and culture	70.4	8.5	11.3	19.7	2.8	0.0	7.0	9.9	100.0	40.8	1.4	57.7
6732	Foundations including international activities	-50.0	36.7	0.0	36.7	113.3	0.0	0.0	113.3	100.0	10.0	0.0	90.0
81	Legal services	25.0	25.0	50.0	75.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total	26.2%	37.9%	27.0%	64.9%	5.9%	0.0%	3.0%	8.9%	100.0%	80.4%	6.2%	13.4%
	1980												
80	Health services	8.7%	49.3%	33.9%	83.2%	1.2%	5.7%	1.2%	8.1%	100.0%	84.7%	6.9%	8.5%
82,892	Education/research	15.2	51.3	19.1	70.5	5.3	6.1	2.9	14.4	100.0	85.1	8.0	6.9
866	Religious organizations	124.6	0.0	0.0	0.0	4.5	-38.5	9.5	-24.6	100.0	72.1	4.5	23.5
83	Social services	30.7	11.7	52.1	63.8	3.1	0.6	1.8	5.5	100.0	84.0	2.5	13.5
864	Civic, social, and fraternal organizations	28.3	13.2	50.9	64.2	1.9	1.9	3.8	7.5	100.0	96.2	1.9	1.9
483,792 84	Arts and culture	64.0	10.0	16.0	26.0	4.0	0.0	6.0	10.0	100.0	50.0	2.0	48.0
6732	Foundations including international activities	-80.5	81.4	0.0	81.4	79.1	0.0	0.0	79.1	100.0	9.3	0.0	90.7
81	Legal services	33.3	0.0	66.7	66.7	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total	[illegible]	[illegible]	[illegible]	64.7%	[illegible]	0.0%	[illegible]	[illegible]	100.0%	80.7%	5.9%	13.4%
	1977												
80	Health services	9.7%	40.1%	32.4%	81.5%	1.2%	6.6%	1.0%	8.8%	100.0%	84.6%	8.6%	7.0%
82/892	Education/research	14.6	52.9	18.2	71.2	5.5	6.2	2.6	14.2	100.0	86.5	7.7	5.8
866	Religious organizations	125.0	0.0	0.0	0.0	4.4	-39.0	9.6	-25.0	100.0	70.6	3.7	25.7
83	Social services	31.6	9.6	53.5	63.2	2.6	0.9	1.8	5.3	100.0	72.8	2.6	24.6
864	Civic, social, and fraternal organizations	28.6	11.9	50.0	61.9	2.4	2.4	4.8	9.5	100.0	95.2	2.4	2.4
84	Arts and culture	65.7	8.6	14.3	22.9	5.7	0.0	5.7	11.4	100.0	45.7	2.9	51.4
6732	Foundations including international activities	-73.1	96.2	0.0	96.2	76.9	0.0	0.0	76.9	100.0	15.4	0.0	84.6
81	Legal services	50.0	0.0	100.0	100.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total	[illegible]	36.4%	26.7%	63.1%	4.6%	0.0%	2.7%	[illegible]	100.0%	[illegible]	[illegible]	13.7%

Sources: See Table 4.1.

*Totals may not add because of rounding.

SIC = Standard Industrial Classification.

[a] See note a in Table 4.1.
[b] See note b in Table 4.1.
[c] See note c in Table 4.1.
[d] See note d in Table 4.1.

Source: Dimensions of the Independent Sector (1986).

INDEPENDENT
SECTOR

RECEIVED
JUN 2 6 1987
Ways and Means
Subcommittee on Oversight

John H. Filer
Chairperson
Linda Flores
Vice Chairperson
John E. Jacob
Vice Chairperson
David Mathews
Vice Chairperson
Fern C. Portnoy
Vice Chairperson
Cecile M. Springer
Vice Chairperson
Eugene R. Wilson
Secretary
James S. Lipscomb
Treasurer
Brian O'Connell
President

Board of Directors
Tomas Arciniega
William L. Bondurant
Alison G. Coolbrith
John E. Corbally
Peter J. Davies
Eugene C. Dorsey
John E. Echohawk
Marion R. Fremont-Smith
Mary Hatwood Futrell
Herman E. Gallegos
John R. Garrison
Luella G. Goldberg
Mary Stewart Hall
Joan W. Harris
Frances Hesselbein
Lyda Hunt Hill
Geneva B. Johnson
Boisfeuillet Jones
James A. Joseph
Reynold Levy
Richard W. Lyman
Barbara Mandel
Astrid E. Merget
Christine Topping Milliken
Steven A. Minter
Patrick F. Noonan
Doris J. O'Connor
Robert L. Payton
Alex J. Plinio
Albert Rees
Charles S. Rooks
Juan Rosario
Terry T. Saario
Bishop Joseph Sullivan
Joseph A. Taller
Alfred H. Taylor, Jr.
Roberta van der Voort
Edward T. Weaver
J. Richard Wilson
David K. Yamakawa, Jr.

June 25, 1987

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Committee on Ways & Means
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Pickle:

In response to your request for additional information, INDEPENDENT SECTOR is pleased to provide the following answers to the questions you posed to us on June 23, 1987.

Your first question asks, "What types of income do you and your member organizations pay unrelated business income tax on?" All of INDEPENDENT SECTOR's activities are related to its exempt purposes; accordingly, we pay no unrelated business income taxes. The members of INDEPENDENT SECTOR are national nonprofit organizations, foundations, and business corporations. The national nonprofit organizations represent a wide variety of 501(c)(3) tax-exempt organizations. The income of our members that would be subject to the unrelated business income tax includes: advertising revenue, rental income from the use of mailing lists and computer time, commissions on insurance sold to member organizations, retail sales of books, and sales of travel and photo services.

Your next question asks, "What is the amount of income and how much tax is paid?" INDEPENDENT SECTOR shares the interest of the Subcommittee on Oversight in obtaining accurate data which could be used to answer this question. Unfortunately, this is privileged information that only the Internal Revenue Service can properly provide. It is the type of information that we requested in our testimony be made available by the Internal Revenue Service and we hope you will support this request.

Your final question was, "What are the major sources of income that are excluded or exempted from UBIT?" Dimensions of the Independent Sector, a statistical profile published in 1986 by INDEPENDENT SECTOR, contains information that is helpful in answering this question. I refer you to Table 4.19 (Attachment #1) and the commentary that accompanies it, which indicates that program service revenue was by far the largest source of support of 501(c)(3) tax-exempt organizations, other than private foundations, in 1982. The next largest source of support was contributions from the government and the general public, followed by investment income. This information was taken from Form 990. The instructions to this form state, "Program services are primarily those that form the basis of an organization's exemption from tax." Examples of program service revenue would include for a hospital, all of its charges from medical services -- whether paid directly by the patients or through Medicare, Medicaid, or other third-party reimbursements. Other examples of program service revenue are tuition received by a school, revenue from admissions to a concert or other performing arts event or to a museum, and royalties received as an author of an educational publication distributed by a commercial publisher.

We have also included, for your information, Tables 4.1 and 4.2 (Attachments #2 and #3), which provide an aggregation of individual estimates for specific subsectors from both private and government sources. Unfortunately, as Treasury and Internal Revenue Service representatives have also pointed out, none of the available information distinguishes adequately unrelated business activities from other receipts. We regret that this information is unavailable.

I hope that you will feel free to contact me if there is any additional information that you would like INDEPENDENT SECTOR to provide.

Sincerely,

Marion R. Fremont-Smith

Marion R. Fremont-Smith
(617) 227-5020, Ext. 5544

Attachments
cc: Russlyn Guritz

Attachment #1

TABLE 4.19

NONPROFIT CHARITABLE ORGANIZATIONS: REVENUE OF 501(C)(3) TAX-EXEMPT ORGANIZATIONS, EXCLUDING PRIVATE FOUNDATIONS, 1982

	All[a]		Hospitals		Schools		Other organizations	
Type of revenue	Amount (billions)	Percent	Amount (billions)	Percent	Amount (billions)	Percent	Amount (billions)	Percent
Total contributions	$ 41.3	21.0%	$ 2.5	2.7%	$ 8.9	25.0%	$29.9	44.0%
Direct public contributions	17.3	8.8	1.5	1.6	3.9	11.0	11.9	17.5
Indirect public contributions (e.g., United Ways)	4.8	2.4	0.4	0.4	0.4	1.1	4.0	5.9
Government grants	19.2	9.8	0.6	0.6	4.6	12.9	13.9	20.4
Program service revenue	124.4	63.4	81.6[a]	87.9	19.7	55.3	23.1	34.0
Dues and assessments	2.5	1.3	0.1	0.1	0.2	0.6	2.2	3.2
Interest	3.4	1.7	1.1	1.2	0.7	2.0	1.5	2.2
Dividends	5.1	2.6	0.7	0.8	1.4	3.9	3.0	4.4
Net rental	0.5	0.3	0.0	0.0	0.1	0.3	0.4	0.6
Other investment income	1.0	0.5	0.1	0.1	0.2	0.6	0.7	1.0
Gain or loss on sale of assets	2.9	1.5	0.1	0.1	1.8	5.1	1.0	1.5
Net income from fund raising	0.9	0.5	0.1	0.1	0.1	0.3	0.7	1.0
Net income from sales	5.0	2.5	3.8	4.1	0.3	0.8	0.9	1.3
Other revenue	9.4	4.8	2.7	2.9	2.2	6.2	4.5	6.6
Total revenue[*]	$196.3	100.0%	$92.8	100.0%	$35.6	100.0%	$68.0	100.0%

Sources: See Table 4.18.

Note: See Notes to Table 4.18.

[*] Totals may not add because of rounding.

[a] A substantial proportion of program service revenue comes from government through payments from individuals using Medicare or Medicaid. This source of government funding from individuals to hospitals was not identified in the *Statistics of Income* study.

▶ In 1982, the largest source of revenue was program service revenue (including payments for services and tuition), which accounted for 63 percent of total revenue. The second largest source of revenue was total contributions, which accounted for 21 percent of total revenue; 11 percent of this came from private sources and 10 percent came from government.

▶ The breakdown of total revenue varied substantially between hospitals, schools, and all other tax-exempt organizations. Program service revenue (payments) constituted 88 percent of total revenue for hospitals compared with 55 percent for schools and 34 percent for all other tax-exempt organizations. Much of the hospital program service revenue is derived from individuals with health insurance from both the private sector and government.

▶ Total contributions represent 25 percent of total revenue for schools and 3 percent for hospitals but are the major source of revenue for all other tax-exempt organizations, representing 44 percent of total revenue. Private contributions make up 12 percent of total revenue for schools and 2 percent for hospitals, compared with 23 percent for all other tax-exempt organizations.

Sourcè: Dimensions of the Independent Sector, 1986.

Attachment #2

TABLE 4.1
INDEPENDENT SECTOR: SOURCES AND DISPOSITION OF ANNUAL FUNDS BY SUBSECTOR, 1984, 1983, 1982, 1980, AND 1977
(In billions of dollars)

		Annual sources of funds									Disposition		
		Private contributions	Payments			Other receipts							
SIC code	Subsector	Total	Private sector	Government sector	Total	Endowment, investment income	Church	Other	Total	Total funds Columns (1)+(4)+(8) or (10)+(11)+(12)	Current operating expenditures[a]	Construction and capital improvements	Other, including change in holding of funds[b]
	1984	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
80	Health services	$10.4	$60.8	$44.5	$105.3	$ 1.4	$ 7.0	$1.6	$10.0	$125.7	$104.7	$ 8.4	$12.6
82,892	Education/research	8.3	30.5	9.7	40.2	3.3	3.5	1.7	8.6	57.1	48.7	4.2	4.2
866	Religious organizations[c]	35.6	-	-	-	1.3	-10.8	2.7	-6.8	28.8	17.1	1.1	10.6
83	Social services	8.0	2.7	9.4	12.1	0.7	0.2	0.4	1.3	21.4	19.9	0.6	0.9
864	Civic, social, and fraternal organizations	2.1	0.9	3.5	4.4	0.1	0.1	0.3	0.5	7.0	6.7	0.1	0.2
483,792, 84	Arts and culture	4.6	0.7	0.9	1.6	0.2	-	0.5	0.7	6.9	3.4	0.1	3.4
6732	Foundations including international activities[d]	-4.2	3.4	-	3.4	7.0	-	-	7.0	6.2	0.6	-	5.6
81	Legal services	0.1	0.1	0.2	0.3	-	-	-	-	0.4	0.4	-	-
	Total[e]	$68.3	$95.7	$68.2	$163.9	$14.0	0.0	$7.2	$21.3	$253.5	$201.5	$14.5	$37.5
	1983												
80	Health services	$ 9.4	$57.7	$40.4	$ 98.1	$ 1.3	$6.4	$1.5	$ 9.2	$116.7	$ 98.2	$ 8.8	$ 9.7
82,892	Education/research	7.7	27.8	9.0	36.8	2.9	3.2	1.5	7.6	52.1	44.7	3.9	3.5
866	Religious organizations	31.9	-	-	-	1.1	-9.9	2.5	-6.3	25.6	17.1	0.9	7.6
83	Social services	7.2	2.5	9.2	11.7	0.6	0.2	0.4	1.2	20.1	18.4	0.7	1.0
864	Civic, social, and fraternal organizations	1.9	0.8	3.2	4.0	0.1	0.1	0.3	0.5	6.4	6.1	0.1	0.2
483,792, 84	Arts and culture	4.2	0.6	0.8	1.4	0.2	-	0.5	0.7	6.3	3.0	0.1	3.2
6732	Foundations including international activities	-3.8	3.0	-	3.0	7.3	-	-	7.3	6.5	0.6	-	5.9
81	Legal services	0.1	0.1	0.2	0.3	-	-	-	-	0.4	0.4	-	-
	Total[e]	$61.6	$89.5	$62.8	$152.3	$13.5	0.0	$6.7	$20.2	$234.1	$188.5	$14.5	$31.1
	1982												
80	Health services	$ 8.4	$51.5	$36.5	$ 88.0	$ 1.2	$5.6	$1.6	$ 8.4	$104.8	$ 88.6	$ 7.7	$ 8.5
82,892	Education/research	7.0	25.3	8.1	33.4	2.8	3.0	1.5	7.3	47.7	40.5	3.8	3.4
866	Religious organizations	28.1	-	-	-	1.0	-8.9	2.2	-5.7	22.4	16.0	0.8	5.6
83	Social services	6.3	2.3	8.9	11.2	0.5	0.2	0.3	1.0	18.5	16.4	0.6	1.5
864	Civic, social, and fraternal organizations	1.7	0.8	2.9	3.7	0.1	0.1	0.2	0.4	5.8	5.6	0.1	0.1
483,792, 84	Arts and culture	5.0	0.6	0.8	1.4	0.2	-	0.5	0.7	7.1	2.9	0.1	4.1
6732	Foundations including international activities	-3.0	2.2	-	2.2	6.8	-	-	6.8	6.0	0.6	-	5.4
81	Legal services	0.1	0.1	0.2	0.3	-	-	-	-	0.4	0.4	-	-
	Total[e]	$55.8	$80.6	$57.4	$138.0	$12.6	0.0	$6.3	$18.9	$212.7	$171.0	$13.1	$28.6
	1980												
80	Health services	$ 6.7	$37.9	$26.1	$ 64.0	$0.9	$4.4	$0.9	$ 6.2	$ 76.9	$ 65.1	$ 5.3	$ 6.5
82,892	Education/research	5.7	19.3	7.2	26.5	2.0	2.3	1.1	5.4	37.6	32.0	3.0	2.6
866	Religious organizations	22.3	-	-	-	0.8	-6.9	1.7	-4.4	17.9	12.9	0.8	4.2
83	Social services	5.0	1.9	8.5	10.4	0.5	0.1	0.3	0.9	16.3	13.7	0.4	2.2
864	Civic, social, and fraternal organizations	1.5	0.7	2.7	3.4	0.1	0.1	0.2	0.4	5.3	5.1	0.1	0.1
483,792, 84	Arts and culture	3.2	0.5	0.8	1.3	0.2	-	0.3	0.5	5.0	2.5	0.1	2.4
6732	Foundations including international activities	-2.6	3.5	-	3.5	3.4	-	-	3.4	4.3	0.4	-	3.9
81	Legal services	0.1	-	0.2	0.2	-	-	-	-	0.3	0.3	-	-
	Total[e]	$45.4	$60.3	$45.5	$105.8	$7.9	0.0	$4.5	$12.4	$163.6	$132.0	$ 9.7	$21.9

TABLE 4.1 (continued)

		Annual sources of funds									Disposition		
		Private contributions	Payments			Other receipts				Total funds columns (1)+(4)+(8) or (10)+(11)+(12)			
SIC code	Subsector	Total	Private sector	Government sector	Total	Endowment, investment income	Church	Other	Total		Current operating expenditures[a]	Construction and capital improvements	Other including change in holding of funds[b]
	1977												
80	Health services	$ 5.0	$25.2	$16.6	$ 41.8	$0.6	$3.4	$0.5	$4.5	$ 51.3	$43.3	$ 4.4	$ 3.6
82,892	Education/research	4.0	14.5	5.0	19.5	1.5	1.7	0.7	3.9	27.4	23.7	2.1	1.6
866	Religious organizations	17.0	-	-	-	0.6	-5.3	1.3	-3.4	13.6	9.6	0.5	3.5
83	Social services	3.6	1.1	6.1	7.2	0.3	0.1	0.2	0.6	11.4	8.3	0.3	2.8
864	Civic, social, and fraternal organizations	1.2	0.5	2.1	2.6	0.1	0.1	0.2	0.4	4.2	4.0	0.1	0.1
483,792, 84	Arts and culture	2.3	0.3	0.5	0.8	0.2	-	0.2	0.4	3.5	1.6	0.1	1.8
6732	Foundations including international activities	-1.9	2.5	-	2.5	2.0	-	-	2.0	2.6	0.4	-	2.2
81	Legal services	0.1	-	0.2	0.2	-	-	-	-	0.2	0.2	-	-
	Total*	$33.8	$41.6	$30.5	$72.1	$5.3	0.0	$3.1	$8.4	$114.2	$ 91.1	$ 7.5	$15.6

Sources: The figures in this table represent an aggregation of many individual estimates made for specific subsectors from both private and government sources. Private sector contributions are estimated primarily from the American Association of Fund-Raising Counsel, Inc., *Giving USA*, various editions; and the Council for Financial Aid to Education, *Survey of Voluntary Support of Education*, various editions. Private contributions that are based on estimates from *Giving USA* are from the 1985 annual report and therefore differ slightly from those in the 1986 annual report. Tables 3.1, 3.2, and 3.3 incorporate the revised 1986 estimates. For health services and education and research, estimates are prepared largely from statistics published by the American Hospital Association, *Hospital Statistics*, various editions; and the U.S. Department of Education (National Center for Education Statistics), *The Condition of Education*, various editions. For social services; civic, social, and fraternal organizations; arts and culture; and legal services, the estimates for payments from the private and government sectors and other receipts are derived from distribution patterns of revenues for fiscal year 1982 developed by the Salamon et al., *Nonprofit Sector Project, Progress Report No. 3*, The Urban Institute. Basic foundation information is from The Foundation Center, *National Data Book*, and *The Foundation Directory*, various editions; and unpublished data from Internal Revenue Service. Published and unpublished data used to estimate employment, wages and salaries, current operating expenditures, and construction and capital improvement are provided principally by government agencies. Published sources include U.S. Department of Labor (Bureau of Labor Statistics), *Employment and Earnings*, various editions, and *Employment and Wages*, various editions; *Non-Profit Service Organizations: 1982*, as assembled by the National Center for Charitable Statistics. Estimates on religious institutions were derived from Interfaith Research Committee of the Commission on Private Philanthropy and Public Needs, "A Study of Religious Receipts and Expenditures in the United States," *Research Papers*, vol.I, 1977.

Dash = Less than $50 million or no entry is made because it does not apply to this subsector.

SIC = Standard Industrial Classification.

*Totals may not add because of rounding.

[a] Specific estimates for wages and salaries, the major component of operating expenditures, are shown in Tables 4.12, 4.13, 4.14, 4.15, and 4.16.

[b] "Other, including change in holding of funds," is a residual item representing the difference between total funds and the sum of current operating expenditures and capital construction and improvements. This residual item serves to balance the total support and the total disposition of this support for each subsector of the independent sector.

[c] Religious organizations both receive contributions and provide them to other organizations of the independent sector. To present net estimates for the independent sector and to estimate the sacerdotal activities of religious organizations, adjustments are made in the receipts for the religious organization that shows the amount of money subtracted for use on nonsacerdotal activities.

[d] Foundation contributions to the various subsectors of the independent sector are included in the rows in the private contributions column, which is why these contributions show up as a negative estimate for foundations. Estimates placed in the cells for payments from the private sector represent contributions to foundations. Such estimates are not included in column totals for private sector payments but are added to the totals for the private contributions column. Foundations essentially are tax-exempt financial institutions engaged in receiving, investing, and distributing funds to organizations of the independent sector, to government institutions such as public universities, and to individuals. In order to avoid counting both the receipt and the distribution of foundation funds in the overall assessment of the total funds for the independent sector, the net contribution of foundations to the independent sector is estimated by adding contribution of foundations to endowment and subtracting the grants of foundations to the independent sector from total receipts of foundations.

Source: Dimensions of the Independent Sector, 1986.

Attachment #3

TABLE 4.2
INDEPENDENT SECTOR: SOURCES AND DISPOSITION OF ANNUAL FUNDS BY SUBSECTOR, 1984, 1983, 1982, 1980, AND 1977
(In percent)

		Annual sources of funds									Disposition		
		Private contributions	Payments			Other receipts							
SIC code	Subsector	Total	Private sector	Government sector	Total	Endowment investment income	Church	Other	Total	Total funds Columns (1)+(4)+(8) or (10)+(11)+(12)	Current operating expenditures[a]	Construction and capital improvements	Other, including change in holding of funds[b]
	1984	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
80	Health services	8.3%	48.4%	35.4%	83.8%	1.1%	5.6%	1.3%	8.0%	100.0%	83.3%	6.7%	10.0%
82.892	Education/research	14.5	53.4	17.0	70.4	5.8	6.1	3.0	15.1	100.0	85.3	7.4	7.4
866	Religious organizations[c]	123.6	0.0	0.0	0.0	4.5	-37.5	9.4	-23.6	100.0	59.4	3.8	36.8
83	Social services	37.4	12.6	43.9	56.5	3.3	0.9	1.9	6.1	100.0	93.0	2.8	4.2
864	Civic, social, and fraternal organizations	30.0	12.9	50.0	62.9	1.4	1.4	4.3	7.1	100.0	95.7	1.4	2.9
483.792, 84	Arts and culture	66.7	10.1	13.0	23.2	2.9	0.0	7.2	10.1	100.0	49.3	1.4	49.3
6732	Foundations including international activities[c]	-67.7	54.8	0.0	54.8	112.9	0.0	0.0	112.9	100.0	9.7	0.0	90.3
81	Legal services	25.0	25.0	50.0	75.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total*	26.9%	37.8%	26.9%	64.7%	5.5%	0.0%	2.8%	8.4%	100.0%	79.5%	5.7%	14.8%
	1983												
80	Health services	8.1%	49.4%	34.6%	84.1%	1.1%	5.5%	1.3%	7.9%	100.0%	84.1%	7.5%	8.3%
82.892	Education/research	14.8	53.4	17.3	70.6	5.6	6.1	2.9	14.6	100.0	85.8	7.5	6.7
866	Religious organizations	124.6	0.0	0.0	0.0	4.3	-38.7	9.8	-24.6	100.0	66.8	3.5	29.7
83	Social services	35.8	12.4	45.8	58.2	3.0	1.0	2.0	6.0	100.0	91.5	3.5	5.0
864	Civic, social, and fraternal organizations	29.7	12.5	50.0	62.5	1.6	1.6	4.7	7.8	100.0	95.3	1.6	3.1
483.792, 84	Arts and culture	66.7	9.5	12.7	22.2	3.2	0.0	7.9	11.1	100.0	47.6	1.6	50.8
6732	Foundations including international activities	-58.5	46.2	0.0	46.2	112.3	0.0	0.0	112.3	100.0	9.2	0.0	90.8
81	Legal services	25.0	25.0	50.0	75.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total*	26.3%	38.2%	26.9%	65.1%	5.8%	0.0%	2.9%	8.6%	100.0%	80.5%	6.2%	13.3%
	1982												
80	Health services	8.0%	49.1%	34.8%	84.0%	1.1%	5.3%	1.5%	8.0%	100.0%	84.5%	7.3%	8.1%
82.892	Education/research	14.7	53.0	17.0	70.0	5.9	6.3	3.1	15.3	100.0	84.9	8.0	7.1
866	Religious organizations	125.4	0.0	0.0	0.0	4.5	-39.7	9.8	-25.4	100.0	71.4	3.6	25.0
83	Social services	34.1	12.4	48.1	60.5	2.7	1.1	1.8	5.4	100.0	88.6	3.2	8.1
864	Civic, social, and fraternal organizations	29.3	13.8	50.0	63.8	2.1	1.7	3.4	6.9	100.0	96.6	1.7	1.7
483.792, 84	Arts and culture	70.4	8.5	11.3	19.7	2.8	0.0	7.0	9.9	100.0	40.8	1.4	57.7
6732	Foundations including international activities	-50.0	36.7	0.0	36.7	113.3	0.0	0.0	113.3	100.0	10.0	0.0	90.0
81	Legal services	25.0	25.0	50.0	75.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total*	26.2%	37.9%	27.0%	64.9%	5.9%	0.0%	3.0%	8.9%	100.0%	80.4%	6.2%	13.4%
	1980												
80	Health services	8.7%	49.3%	33.9%	83.2%	1.2%	5.7%	1.2%	8.1%	100.0%	84.7%	6.9%	8.5%
82.892	Education/research	15.2	51.3	19.1	70.5	5.3	6.1	2.9	14.4	100.0	85.1	8.0	6.9
866	Religious organizations	124.6	0.0	0.0	0.0	4.5	-38.5	9.5	-24.6	100.0	72.1	4.5	23.5
83	Social services	30.7	11.7	52.1	63.8	3.1	0.6	1.8	5.5	100.0	84.0	2.5	13.5
864	Civic, social, and fraternal organizations	28.3	13.2	50.9	64.2	1.9	1.9	3.8	7.5	100.0	96.2	1.9	1.9
483.792, 84	Arts and culture	64.0	10.0	16.0	26.0	4.0	0.0	6.0	10.0	100.0	50.0	2.0	48.0
6732	Foundations including international activities	-60.5	81.4	0.0	81.4	79.1	0.0	0.0	79.1	100.0	9.3	0.0	90.7
81	Legal services	33.3	0.0	66.7	66.7	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total*	27.7%	36.8%	27.9%	64.7%	4.8%	0.0%	2.8%	7.6%	100.0%	80.7%	5.9%	13.4%
	1977												
80	Health services	9.7%	49.1%	32.4%	81.5%	1.2%	6.6%	1.0%	8.8%	100.0%	84.4%	8.6%	7.0%
82/892	Education/research	14.6	52.9	18.2	71.2	5.5	6.2	2.6	14.2	100.0	86.5	7.7	5.8
866	Religious organizations	125.0	0.0	0.0	0.0	4.4	-39.0	9.6	-25.0	100.0	70.6	3.7	25.7
83	Social services	31.6	9.6	53.5	63.2	2.6	0.9	1.8	5.3	100.0	72.8	2.6	24.6
864	Civic, social, and fraternal organizations	28.6	11.9	50.0	61.9	2.4	2.4	4.8	9.5	100.0	95.2	2.4	2.4
84	Arts and culture	65.7	8.6	14.3	22.9	5.7	0.0	5.7	11.4	100.0	45.7	2.9	51.4
6732	Foundations including international activities	-73.1	96.2	0.0	96.2	76.9	0.0	0.0	76.9	100.0	15.4	0.0	84.6
81	Legal services	50.0	0.0	100.0	100.0	0.0	0.0	0.0	0.0	100.0	100.0	0.0	0.0
	Total*	29.6%	36.4%	26.7%	63.1%	4.6%	0.0%	2.7%	7.4%	100.0%	79.8%	6.6%	13.7%

Sources: See Table 4.1.

*Totals may not add because of rounding.

SIC = Standard Industrial Classification.

[a] See note a in Table 4.1.

[b] See note b in Table 4.1.

[c] See note c in Table 4.1.

Source: Dimensions of the Independent Sector, 1986.

INDEPENDENT
SECTOR

RECEIVED
JUL 6 1987
Ways and Means
Subcommittee on Oversight

John H. Filer
Chairperson
Linda Flores
Vice Chairperson
John E. Jacob
Vice Chairperson
David Mathews
Vice Chairperson
Fern C. Portnoy
Vice Chairperson
Cecile M. Springer
Vice Chairperson
Eugene R. Wilson
Secretary
James S. Lipscomb
Treasurer
Brian O'Connell
President

Board of Directors
Tomas Arciniega
William L. Bondurant
Alison G. Coolbrith
John E. Corbally
Peter J. Davies
Eugene C. Dorsey
John E. Echohawk
Marion R. Fremont-Smith
Mary Hatwood Futrell
Herman E. Gallegos
John R. Garrison
Luella G. Goldberg
Mary Stewart Hall
Joan W. Harris
Frances Hesselbein
Lyda Hunt Hill
Geneva B. Johnson
Boisfeuillet Jones
James A. Joseph
Reynold Levy
Richard W. Lyman
Barbara Mandel
Astrid E. Merget
Christine Topping Milliken
Steven A. Minter
Patrick F. Noonan
Doris J. O'Connor
Robert L. Payton
Alex J. Plinio
Albert Rees
Charles S. Rooks
Juan Rosario
Terry T. Saario
Bishop Joseph Sullivan
Joseph A. Taller
Alfred H. Taylor, Jr.
Roberta van der Voort
Edward T. Weaver
J. Richard Wilson
David K. Yamakawa, Jr.

July 3, 1987

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Committee on Ways and Means
1105 Longworth House Office Building
Washington, DC 20515

Dear Jake:

I am naturally alarmed that in the final day of your important hearing on competition and unrelated business income, you expressed concern that INDEPENDENT SECTOR had withheld important information. As reported to me, you said, "INDEPENDENT SECTOR is playing hardball with Congress. They have an obligation to provide us with this information. It is unacceptable for them to stonewall this committee."

I couldn't be more chagrined that you garnered that impression. We provided every scrap of information we thought might be helpful. Our frustration and yours is that much of what we all need is just not available presently. To try to be more responsive than we were prepared to be when your notice of hearings was issued, we tried a hurry-up survey of our members, but because it was hurried and was limited to our members which are national rather than local organizations, the results were completely useless. It's just one more indication that a more orderly process for collecting such information is needed. That was at the heart of our recommendations. In order to be certain that no one there feels we are keeping any information from you, I am enclosing the survey questions and analysis of responses. Anything we might have tried to draw from it would have been misleading.

I understand that our situation with you was compounded when our witness, Marion R. Fremont-Smith, a member of our Board responded to one of your questions that she could not fulfill your request for some specific

A NATIONAL FORUM TO ENCOURAGE GIVING, VOLUNTEERING AND NOT • FOR • PROFIT INITIATIVE
1828 L Street, N.W. • Washington, D.C. 20036 • (202) 223-8100
SUCCESSOR TO THE COALITION OF NATIONAL VOLUNTARY ORGANIZATIONS AND THE NATIONAL COUNCIL ON PHILANTHROPY

information because the information was "privileged" and that you or others interpreted this as our unwillingness to provide information known to us. I hope her subsequent letters to you have clarified that we have absolutely no access to that information because it is legally defined as privileged by the Internal Revenue Service and its sources.

That episode and your understandable frustration that we -- _and_ IRS, _and_ Treasury, _and_ GAO, and all the others to whom you turned -- could not supply what you needed caused you to suspect that INDEPENDENT SECTOR and perhaps others were holding out on you. I know that for INDEPENDENT SECTOR that couldn't be further from the truth.

I am eager to be as fully responsive as humanly possible to your requests and needs for information. Toward that end, I am eager to meet with you to determine what we can do through a more organized survey and/or other means. It is also important to me and the organizations we represent to talk to you firsthand to be absolutely certain that you know we did not and would never withhold information important to your investigations.

I hope there will be an early opportunity to meet with you.

Sincerely,

Brian

Brian O'Connell
President

Enclosures
BO'C/bl

cc: Barbara Pate
Beth Vance
Russlyn Guritz

Attachment #1

QUESTIONNAIRE ON:

- The relationship between nonprofit organizations and small business.
- The Unrelated Business Income Tax.

Late in 1984, INDEPENDENT SECTOR surveyed its members regarding the Unrelated Business Income Tax (UBIT) and the relationship between nonprofit organizations and small business providing similar goods and services. At that time, we needed the very useful information which you provided to help us respond to allegations of "unfair competition by nonprofit organizations" made by the U.S. Small Business Administration and the representatives of a few trade associations.

The Subcommittee on Oversight of the House Ways and Means Committee is expected to hold hearings on UBIT and competition between for-profits and nonprofits this spring. We need current survey results to properly respond to the inquiries of the Subcommittee.

We have tried to keep the questionnaire brief, to encourage wide response. It would be particularly helpful if you would send this questionnaire on to your affiliates so that we can get comprehensive information on these issues. We would like to have all survey results returned to INDEPENDENT SECTOR by May 15, 1987.

I. Nature of Nonprofit Activities

A. What is/are the exempt purpose(s) of your organization (e.g., arts, culture and humanities, combined appeals, education and instruction, environment, foundation, health, human services, international, religion, public advocacy and community action, youth development)?

B. What types of income-producing activities are carried on by your organization?

1. Major sources of revenue --

	% of Total Revenue
a. Gifts from Foundations	
b. Gifts from Corporations	
c. Individual Donations	
d. Membership Dues	
e. Fees from Service Recipients	
f. Fees from Third-Party Payors	
g. Bequests	
h. Endowment/investment income	
i. Other Sources (please specify below)	

2. Where possible, please provide any earmarked purposes of the revenue sources listed above. (e.g., a foundation grant was used for publication and training materials).

C. Over the past five years, have the revenues received from each of the following sources changed?

Source	Increased	Unchanged	Decreased
a. Gifts from Foundations	( )	( )	( )
b. Gifts from Corporations	( )	( )	( )
c. Individual Donations	( )	( )	( )
d. Membership Dues	( )	( )	( )
e. Fees from Service Recipients	( )	( )	( )
f. Fees from Third-Party Payors	( )	( )	( )
g. Bequests	( )	( )	( )
h. Endowment/investment income	( )	( )	( )
i. Other Sources (please specify below)	( )	( )	( )

II. Nature of the Relationship Between Nonprofits and Their For-Profit Counterparts

A. Is your organization carrying out income-producing activities which compete with similar or identical income-producing activities of for-profits? Yes _____ No _____
If so, are the businesses small or large?

1. How do the services of your organization differ from those offered by for-profit competitors?

2. Is the atmosphere between your organization and for-profit businesses involved in the same market competitive or cooperative?

3. To what extent do taxable businesses engage in income-producing activities that traditionally have been performed by your organization and do you foresee emerging trends that would expand these activities?

4. If for-profits have raised concerns about competition from your organization, is it because (1) your organization has developed new revenue-raising activities, (2) evolving and expanding community needs for your services have caused your organization to adapt its programs accordingly, or (3) other reasons? If other reasons, please specify.

B. To what extent, if any, do the current income-producing activities of your organization relate to federal budget cuts or other government policies or to increased demand for your services?

III. The Unrelated Business Income Tax (See attachment for a general description of the unrelated business income tax.)

A. Did your organization file an Internal Revenue Service Form 990T (the form for unrelated business income) on its most recent annual returns filed with the IRS?

Yes _____ No _____

B. If you have unrelated business income, please briefly describe the operations which generate these funds.

C. In dollars, how much income did you report on the IRS Form 990T and how much tax did you pay for the years reported?

Year	Income Reported	Tax Paid
1986		
1985		
1984		
1983		
1982		

D. 1. Has the Internal Revenue Service issued a ruling within the past five years regarding any of your income-producing activities, which caused your organization to begin paying tax on that income? Yes _____ No _____

If yes, how recent was the ruling? ______________________

2. Did this ruling have a substantial impact on your organization's income and, if so, please describe?

E. 1. Have you ever been audited by the IRS for unrelated business income? Yes _____ No _____

2. Approximately when was the audit? _______________________

3. What was the outcome?

F. Have you ever considered some new revenue source and rejected it because of a possible unrelated business income tax?

Yes ______ No _____

G. Have there been in the last two years, changes in tax laws (sales, use, property, etc.) at the state or local level that resulted in increased taxes for your organization?
Yes _____ No _____ If yes, please describe briefly.

H. Have you developed policies and guidelines to address unrelated business income and/or concerns about competition between your organization and small business? Yes _____ No _____
If yes, please send a copy of the guidelines and/or policies with your completed survey.

I. Do you have a for-profit subsidiary? Yes _____ No _____
If so, what is its purpose?

J. Please check whether your questionnaire response is for a national _____, state _____, or local _____ organization.

Name of Organization: ______________________________
____

Address: ______________________________
____

Phone No: ______________________

PLEASE RETURN TO: Mark Cullinane
INDEPENDENT SECTOR
1828 L Street, N.W., Suite 1200B
Washington, DC 20036

(202) 223-8100

Attachment

Unrelated Business Income

With certain exceptions, net income earned by a nonprofit organization from an activity that is not related to its charitable purpose is taxed. Following is a broad outline of the general principles applicable to the taxation of unrelated business income. Unrelated business income is taxed if it is earned:

- from a trade or business,
- which is regularly carried on, and
- which is not substantially related to the organization's exempt purpose.

The definition of unrelated trade or business does not include an activity:

- in which substantially all the work is done by volunteers;
- which is carried on primarily for the convenience of members, students, patients, officers or employees; or
- which is the sale of merchandise substantially all of which has been received as gifts or contributions.

Excluded from unrelated business taxable income are:

- royalties, dividends, interest and annuities;
- most rents;
- capital gains and losses;
- income from research performed for the government.

Attachment #2

RESULTS OF QUESTIONNAIRE

- Questionnaires were sent to all of our 355 nonprofit organization members.
- 60 Questionnaires were returned.
- Response rate: 16.6 percent.

RESPONSES

Type of Organization	# of Responses	% of Total
Education/Training	16	27%
Medical	12	20%
Environmental/Wildlife	6	10%
Religion	4	7%
Advocacy	4	7%
Arts/Cultural	5	8%
Child/Youth/Families	6	10%
International	7	12%
TOTAL	60	

QUESTION I.B.1.: WHAT TYPES OF INCOME-PRODUCING ACTIVITIES ARE CARRIED ON BY YOUR ORGANIZATION?

SOURCES OF SUPPORT

(Number and Percentage of Respondents
Receiving Various Types of Support)

Sources of Support for Nonprofit Organizations	Number	Percentage
Foundations	41	68%
Corporations	42	70%
Donations	42	70%
Dues	38	63%
Fees for Service	25	42%
Fees from 3rd Parties	9	7%
Bequests	15	25%
Endowment/Investment	35	58%
Other	24	40%
Government Contracts	15	25%

QUESTION I.C.:

OVER THE PAST FIVE YEARS, HAVE THE REVENUES RECEIVED FROM EACH OF THE FOLLOWING SOURCES CHANGED?

Number of Organizations Experiencing Changes in Sources of Support

		Increase	Unchanged	Decreased
a.	Foundations	29	10	5
b.	Corporations	26	15	7
c.	Donations	38	6	2
d.	Dues	31	7	2
e.	Fees for Service	19	10	5
f.	Fees from 3rd Parties	6	9	2
g.	Bequests	18	11	1
h.	Endowment/Investment	26	8	6
i.	Other	27	6	2

QUESTION II.A:

IS YOUR ORGANIZATION CARRYING OUT INCOME-PRODUCING ACTIVITIES WHICH COMPETE WITH SIMILAR OR IDENTICAL INCOME-PRODUCING ACTIVITIES OF FOR-PROFITS?

IF SO, ARE THE BUSINESSES SMALL OR LARGE?

33 percent answered YES

57 percent answered NO

Of those who answered "YES," nearly half compete with small businesses.

"YES" respondents were evenly distributed among the following categories: health/medical; arts; education; environmental.

QUESTION II.A.2:

IS THE ATMOSPHERE BETWEEN YOUR ORGANIZATION AND FOR-PROFIT BUSINESSES INVOLVED IN THE SAME MARKET COMPETITIVE OR COOPERATIVE?

Health/Medical groups responded that the atmosphere is both competitive and cooperative.

13 responses to question: 38% of 13 responded "competitive"
62% of 13 responded "cooperative"

QUESTION II.A.4:

IF FOR-PROFITS HAVE RAISED CONCERNS ABOUT COMPETITION FROM YOUR ORGANIZATION, IS IT BECAUSE (1) YOUR ORGANIZATION HAS DEVELOPED NEW REVENUE-RAISING ACTIVITIES, (2) EVOLVING AND EXPANDING COMMUNITY NEEDS FOR YOUR SERVICES HAVE CAUSED YOUR ORGANIZATION TO ADAPT ITS PROGRAM ACCORDINGLY, OR (3) OTHER REASONS? IF OTHER REASONS, PLEASE SPECIFY.

One group said the organization has developed new fund-raising activities.

Two groups said the evolving community has caused the organization to change.

Most groups responded that they were unaware of any concerns raised by for-profits.

QUESTION III.A.:

DID YOUR ORGANIZATION FILE AN INTERNAL REVENUE SERVICE FORM 990-T (THE FORM FOR UNRELATED BUSINESS INCOME) ON ITS MOST RECENT ANNUAL RETURNS FILED WITH THE IRS?

42 Responses to this Question: 19% of 42 responded "YES"
81% of 42 responded "NO"

QUESTION III.B:

IF YOU HAVE UNRELATED BUSINESS INCOME, PLEASE DESCRIBE BRIEFLY THE OPERATIONS WHICH GENERATE THESE FUNDS.

Six respondents listed the following activities: advertisements in publications, rentals of mailings lists and computer time, commissions on the sale of insurance to member organizations, retail sales of books, and sales of travel and photo services.

QUESTION III.C.:

IN DOLLARS, HOW MUCH INCOME DID YOU REPORT ON THE IRS FORM 990-T AND HOW MUCH TAX DID YOU PAY FOR THE YEARS REPORTED?

Six respondents reported the following: Three advocacy organizations reported net losses in two or more years between 1982 and 1986; the first reported losses of $800 in 1983 and $969 in 1984; the second reported losses of $25,347 in 1983, $34,826 in 1984, $12,973 in 1985 and $153,406 in 1986; and the third reported losses of $40,000 in 1982, $45,000 in 1983, $48,000 in 1984, $50,000 in 1985 and $45,000 in 1986. One human service organization reported $193,000 in unrelated business income in 1985 on which $595 in taxes were paid. One cultural organization reported between $2,000 and $6,000 in unrelated business income in each year from 1982 to 1986. No taxes were paid on this income because it was below the $10,000 threshold for payment of UBIT. Our last bit of information comes from an environmental organization which reported losses of $18,659 in 1983, $80,210 in 1984, $144,520 in 1985, and income of $56,606 in 1986. The organization's earnings of unrelated business income in 1986 yielded a tax payment of $10,052.

QUESTION III.D.1 and 2.:

1. HAS THE INTERNAL REVENUE SERVICE ISSUED A RULING WITHIN THE PAST FIVE YEARS REGARDING ANY OF YOUR INCOME-PRODUCING ACTIVITIES, WHICH CAUSED YOUR ORGANIZATION TO BEGIN PAYING TAX ON THAT INCOME?

16% of 37 responded "YES"
84% of 37 responded "NO"

2. DID THIS RULING HAVE A SUBSTANTIAL IMPACT ON YOUR ORGANIZATION'S INCOME AND, IF SO, PLEASE DESCRIBE?

3 responded that their income was "UBIT"
3 responded that their income was "NOT UNRELATED"
No respondents had a change in tax status

QUESTION III.E. 1, 2 AND 3:

HAVE YOU EVER BEEN AUDITED BY THE IRS FOR UNRELATED BUSINESS INCOME?

The IRS audited 16 percent of respondents for unrelated business income, but no organization has been required to pay unrelated business income taxes as a result of the audit.

QUESTION III.F.:

HAVE YOU EVER CONSIDERED SOME NEW REVENUE SOURCE AND REJECTED IT BECAUSE OF A POSSIBLE UNRELATED BUSINESS INCOME TAX?

15% of 40 responded "YES"
85% of 40 responded "NO"

QUESTION III.G.:

HAVE THERE BEEN IN THE LAST TWO YEARS, CHANGES IN TAX LAWS (SALES, USE, PROPERTY, ETC.) AT THE STATE OR LOCAL LEVEL THAT RESULTED IN INCREASED TAXES FOR YOUR ORGANIZATION? IF YES, PLEASE DESCRIBE BRIEFLY.

6% of 36 responded "YES"
94% of 36 responded "NO"

QUESTION III.H.:

HAVE YOU DEVELOPED POLICIES AND GUIDELINES TO ADDRESS UNRELATED BUSINESS INCOME AND/OR CONCERNS ABOUT COMPETITION BETWEEN YOUR ORGANIZATION AND SMALL BUSINESS?

1% of 42 responded "YES"
98% of 42 responded "NO" (i.e., all the rest)

QUESTION III.I.:

DO YOU HAVE A FOR-PROFIT SUBSIDIARY? IF SO, WHAT IS ITS PURPOSE?

11% of 42 responded "YES"
90% of 42 responded "NO"

INDEPENDENT
SECTOR

RECEIVED
OCT - 2 1987
Ways and Means
Subcommittee on Oversight

John H. Filer
Chairperson
Linda Flores
Vice Chairperson
John E. Jacob
Vice Chairperson
David Mathews
Vice Chairperson
Fern C. Portnoy
Vice Chairperson
Cecile M. Springer
Vice Chairperson
Eugene R. Wilson
Secretary
James S. Lipscomb
Treasurer
Brian O'Connell
President

Board of Directors
Tomas Arciniega
William L. Bondurant
Alison G. Coolbrith
John E. Corbally
Peter J. Davies
Eugene C. Dorsey
John E. Echohawk
Marion R. Fremont-Smith
Mary Hatwood Futrell
Herman E. Gallegos
John R. Garrison
Luella G. Goldberg
Mary Stewart Hall
Joan W. Harris
Frances Hesselbein
Lyda Hunt Hill
Geneva B. Johnson
Boisfeuillet Jones
James A. Joseph
Reynold Levy
Richard W. Lyman
Barbara Mandel
Astrid E. Merget
Christine Topping Milliken
Steven A. Minter
Patrick F. Noonan
Doris J. O'Connor
Robert L. Payton
Alex J. Plinio
Albert Rees
Charles S. Rooks
Juan Rosario
Terry T. Saario
Bishop Joseph Sullivan
Joseph A. Taller
Alfred H. Taylor, Jr.
Roberta van der Voort
Edward T. Weaver
J. Richard Wilson
David K. Yamakawa, Jr.

September 28, 1987

The Honorable J. J. Pickle
Chairman, Oversight Subcommittee
1105 Longworth House Office Building
Washington, DC 20515

Dear Jake:

I am enclosing a final copy of INDEPENDENT SECTOR's "Comments on Treasury's Testimony Before the Subcommittee on Oversight Regarding the Unrelated Business Income Tax," which was approved by our Board of Directors on September 16.

With a membership of 650, we cannot be certain that all of our members agree with positions taken by our Board. While we cannot speak for all of the members of INDEPENDENT SECTOR, we did want you to know that both the IS Government Relations Committee and the Board of Directors have approved the position.

Sincerely,

Brian

Brian O'Connell
President

Enclosure
BO'C/bl

A NATIONAL FORUM TO ENCOURAGE GIVING, VOLUNTEERING AND NOT • FOR • PROFIT INITIATIVE
1828 L Street, N.W. • Washington, D.C. 20036 • (202) 223-8100
SUCCESSOR TO THE COALITION OF NATIONAL VOLUNTARY ORGANIZATIONS AND THE NATIONAL COUNCIL ON PHILANTHROPY

September 23, 1987

COMMENTS ON TREASURY'S TESTIMONY BEFORE THE SUBCOMMITTEE ON OVERSIGHT REGARDING THE UNRELATED BUSINESS INCOME TAX

The comments below were prepared by a broad coalition of nonprofit organizations convened by INDEPENDENT SECTOR, and have been approved by INDEPENDENT SECTOR's Board of Directors.

"Substantially Related" Test

INDEPENDENT SECTOR agrees with Treasury's statement that the relatedness test has "conceptual merit." The relatedness test is the linchpin of the UBIT rules, identified in our testimony as a workable standard to distinguish exempt income from taxable income. This standard is the most logical method for making an initial determination about the tax status of an exempt activity, as it identifies whether or not the activity is substantially related to the organization's exempt purposes.

The present standard does not, contrary to charges, allow virtually any sort of activity to be conducted on a tax-free basis if an exempt organization can somehow connect the activity to very broadly stated charitable purposes. Instead, the regulations already require that an income-producing activity not be "conducted on a larger scale than is reasonably necessary for performance of [the related exempt] functions." Regs. Sections 1.513-1(d)(3). Moreover, the Internal Revenue Service (IRS) and the courts have required, in many instances, not only that income-producing activities help achieve exempt purposes, but that they be conducted in ways that are different from, or subject to different standards than, normal commercial enterprises.

Therefore, current law, under the relatedness standard, provides important protections against abusive situations, particularly if it is more effectively enforced. The overwhelming weight of authority under the relatedness standard is that exempt organizations are subject to tax on activities run on a normal commercial basis, especially where those activities are not inherently charitable. The requisite differences can be in the form of different standards for running an operation -- for example, the university press that keeps scholarly books in print long after a commercial house would have remaindered the inventory, assuming the books would have been published commercially in the first place. They may take the form of different pricing policies -- not giving the service or goods away free, but insuring that the price structure is such that a broad range of the community is served, abjuring the "cream-skimming" that for-profit service businesses can enjoy. Given that there is already a substantial requirement for differentiation from straight commercial purposes and practices, there is no need to introduce a formal "commercialization" standard.

Reporting

Treasury views the relatedness test, as interpreted by the regulations, positively, and recommends improved reporting to increase enforcement and compliance and to provide a basis for further review of the test. INDEPENDENT SECTOR recommends four changes as a means of improving reporting.

First, nonprofit organizations should be required to disclose their gross and net taxable unrelated business income on Form 990. Disclosure of this information -- which is now confidential by statute -- is supported by the public trust bestowed on nonprofit organizations through charitable contributions and the tax exemption. It will serve to clarify which entities have substantial gross and net unrelated business income and assist in public accountability of exempt organizations.

Second, a great deal could be learned about the activities which generate unrelated business income by requiring the Statistics of Income Division at the IRS to tabulate aggregate data from Form 990-T. INDEPENDENT SECTOR has heard that a full Statistics of Income study of Form 990-T is planned for 1988. We applaud these plans and urge the IRS to produce an annual study of Form 990-T.

Third, we recommend the development of a separate form to be filed upon the creation of a controlled subsidiary. A separate form would include questions regarding reasons for establishment, directors and officers, capitalizations and expense allocations. The existing question number 80 on Form 990 should also be maintained for annual reporting regarding subsidiaries.

A final recommendation in the area of improved reporting is a requirement that the IRS release all private letter rulings in the exempt organization area. Greater disclosure of the

IRS's position will make it easier for nonprofit organizations to comply with the relatedness standard.

Volunteer-Operated Businesses

In 1985, 89 million Americans 14 years of age or older, reported volunteering an average of 3.5 hours per week, or a total of 16.1 billion hours for the year. The United States should celebrate the fact that almost one-half of its people 14 years of age or older are volunteering to the causes and institutions of their choice. The vast bulk of this volunteer effort goes into direct program service; however, a significant part is devoted to fund-raising, some of it in the form of staffing of business activities covered by the volunteer labor exemption.

INDEPENDENT SECTOR recommends retention of the current exception for businesses operated by volunteers, in the absence of specific abuses. We believe that in virtually all cases protections are provided by the benchmark for a volunteer-operated business under which 85 percent of the labor in an operation must be voluntary.

The 85 percent threshold is a strong impediment to volunteer operations becoming competitive. Usually, continuity of personnel and operations -- important ingredients in a competitive business -- are not available to the volunteer business. To the extent that the activities of a volunteer business do compete, consideration should be given to the fact that taxing these activities would be extremely complex administratively. As Treasury acknowledges, not deducting for donated labor overstates taxable income because volunteers are not compensated for their services, while attempting to impute a value to such labor would pose serious practical difficulties.

Convenience Exception

It is our view that activities offered for the convenience of members, students, patients, officers or employees are often vital to carrying out an organization's exempt purposes. Many of the activities currently exempt under the convenience exception are related; however, for the purposes of simplification as well as compliance and enforcement, the convenience exception should be preserved. Three subsectors of the independent sector -- higher education, arts and humanities, and hospitals -- depend greatly on the convenience exception.

In response to Treasury's suggested review of the convenience exception as it affects colleges and universities, INDEPENDENT SECTOR recommends that General Counsel Memorandum 35811 (May 7, 1974) be used as a basis for Treasury regulations through a formal rulemaking process. This memorandum addresses the sale of items in campus book stores. As stated in higher education's letter from Sheldon Elliot Steinbach, Vice President and General Counsel of the American Council on Education, "the memorandum suggested that the exemption should apply to the sale of items used in the conduct of educational programs; items with an ordinary useful life of one year or less; items of relatively low cost and recurrent demand; items that promote the institution by displaying its name or logo; or items not readily available from other sources in the immediate geographic area." INDEPENDENT SECTOR accepts these factors as reasonable limitations on the sale of convenience items in college and university book stores.

Income from hospital facilities such a cafeterias, gift shops, parking lots, and pharmacies has been found by the IRS not to be unrelated business taxable income in certain circumstances, generally because it is substantially related to the exempt purpose of the organization. It does not appear that these rulings have been challenged as an inappropriate application of the law or as unfair to for-profit businesses. Therefore, if the convenience exception is narrowed, Congress should make clear that it does not intend to change the results of these IRS rulings regarding hospital activities.

Institutions devoted to arts, humanities and science rely on the convenience exception to support the provision of food, coat room, parking and similar services to the public. These services facilitate involvement with the arts by making the museum, ballet company, opera, concert or play more accessible. The convenience exception should be maintained to encourage the availability of arts through services that are related to the organization's exempt purposes.

Donated Property

INDEPENDENT SECTOR supports Treasury's conclusion that the exception for the sale of donated property is justified. The donation of used goods to nonprofit organizations has been a long-established charitable activity. The exception from UBIT of income derived from the sale of donated property allows the needy to purchase items at reduced prices which, at the same time, are sufficient to enable the nonprofit organization to recover the costs of collecting and refurbishing the items. Many organizations provide vocational training to disabled individuals in connection with the refurbishment and sale of donated property. Impairment of this exception would diminish the availability of donated goods to those in need and training opportunities for the disabled.

Allocation of Expenses

Treasury's request for an allocation method based on total available time, in effect, asks that Congress reverse the decision of the Second Circuit in the case, Renssalaer Polytechnic Institute v. Commissioner, 732 F. 2d 1058 (2nd Cir. 1984). This case dealt with the problem of how to apportion fixed costs of a facility used for exempt purposes, but rented for unrelated use part of the time. The court held that it is proper for the exempt organization, in computing its deductions from rental income, to allocate the fixed costs to unrelated income based on the unrelated income as a proportion of the total time the facility is used for both exempt and unrelated purposes, not the total number of days in the year, counting idle time as exempt use.

Broadly speaking, once an exempt organization's activity is taxable, it should be able to determine the amount of taxable income from the activity under the same accounting rules as taxable income. The basic statutory principle -- which the IRS does not, and should not be allowed to dispute -- is that costs directly attributable to unrelated use of dual-use facilities can be deducted. Just how that allocation is calculated is a technical detail of tax accounting. The RPI decision is a reasonable application of the statutory principle. Treasury acknowledges that RPI is a "case of first impression," suggesting this is not a matter of widespread concern, and certainly not a significant area of abuse.

The IRS is simply trying to appeal to Congress to reverse a litigation loss -- on an issue they say they hope to win in court anyway. (Treasury's analogy between the exempt- and unrelated-use allocation problem and that of allocating expenses between personal and for-profit use is inapposite. Personal use, almost by definition, is a continuing proposition; here the issue is allocating between two distinct kinds of business use.)

Treasury also proposes to limit all deductions from gross unrelated income to the fair market value of the service provided the income-producing enterprise. This idea, which sounds good at first blush, would be an administrative horror.

Measuring the "market value" of an internally provided service would be extraordinarily complex. The current rule, which requires reasonable allocation of actual costs between exempt and unrelated uses, provides full protection against abusive efforts to lay off excessive costs on unrelated income. Current law, if enforced seriously, gives the IRS adequate weapons (e.g., the trade or business requirement) to prevent deliberate loss-generating activities entered into only to shelter other unrelated income.

Fragmentation Rule

INDEPENDENT SECTOR accepts Treasury's position on the fragmentation rule, the rule that subdivides an aggregate of activities into related and unrelated parts. We acknowledge the administrative burden associated with reviewing the relatedness of each item in an organization's inventory; nevertheless, the fragmentation rule separates properly what is unrelated from what is exempt.

Specific Deduction

INDEPENDENT SECTOR supports Treasury's recommendations to increase the specific deduction allowed against unrelated business income from $1,000 to $5,000, and to phase out the deduction for organizations with a substantial amount of unrelated business income, perhaps in excess of $50,000.

An increase in the deduction -- set at $1,000 in 1950 -- is sensible in light of the rate of inflation. Further, setting the deduction at $5,000 avoids a needless administrative burden for small nonprofit organizations with very little income. This rationale is not fitting in situations where an organization brings in a substantial amount of unrelated business income. Consequently, we will support a proposal to phase out the deduction above a threshold of significant unrelated business income.

Controlled Subsidiaries

Treasury recommends tightening the definition of "controlled subsidiary" by lowering the threshold for control from the current 80 percent interest in voting power to a 50 percent interest in voting power or ownership. Treasury's recommendation establishes a reasonable measure of control that

INDEPENDENT SECTOR will support provided that the change applies prospectively.

Aggregation

Treasury recommends aggregating the activities of an exempt organization's subsidiaries to determine that organization's primary purpose. Given that unrelated, taxable businesses conducted internally are taken into account in deciding whether an organization is exempt, there is no reason in principle to treat the unrelated businesses of controlled subsidiaries differently. It should be made clear, however, that the income of subsidiaries counts as related for these purposes if the activity is related to the purpose of a tax-exempt subsidiary even if those purposes are different from those of the parent, and also if the activity, though conducted by a taxable subsidiary, is in fact related to the purposes of the exempt parent.

There is a broader question why, if an organization is spending on charity in reasonable proportion to its income, it should make any difference whether that income comes from endowment or from a controlled or integrated unrelated business. It is a sound goal to insure that all unrelated income is taxed, but it is not so clear why it should make a difference to the exemption of an organization whether it invests in a controlled taxable business rather than in a lot of different portfolio investments. The traditional argument that running unrelated businesses diverts attention from charity is a bit threadbare -- it is not clear why it is any better to have the board worry about fundraising or portfolio management than an unrelated business. The problem of inadequate and undermanaged charitable programs -- or unreasonable accumulations of income left unspent on charity -- should be handled directly, and not just where the reason is apparent diversion of effort to a controlled unrelated business.

Passive Investment Income of Social Welfare Groups

Treasury recommends that the passive investment income of social welfare groups [501(c)(4)s] should be taxable unless the income is permanently set aside for charitable purposes.

INDEPENDENT SECTOR opposes this change. Section 501(c)(4) serves a useful purpose in encouraging a range of community benefit activities that, while not meeting the strict standards for charitable tax-exemption under section 501(c)(3), nonetheless clearly serve the public interest. For example, a community preservation organization may qualify for exemption under section 501(c)(4), but not under section 501(c)(3), because the private benefit to local property owners is inconsistent with charitable status. While withholding the benefit of the charitable contribution deduction, Congress has seen fit to encourage these public welfare activities by exempting the organization's income, including investment income, from tax.

Treasury has not provided a convincing rationale for reversing this long-standing judgment. Section 501(c)(4) organizations are already taxable on investment income spent on political campaign activities. Treasury argues that section 501(c)(4) organizations should not be allowed to use tax-exempt investment income to fund lobbying activities. There is simply no general rule that lobbying activities must be conducted with nondeductible funds. Business corporations can deduct direct lobbying costs under section 162(e), and section 501(c)(3) organizations can spend on lobbying from their general funds, whether raised by deductible contributions or investment income, up to defined limits. Thus, the proposed change would make section 501(c)(4) considerably more restrictive than the rules for either business corporations or section 501(c)(3) charities.

Passive Investment Income of Public Charities

Treasury recommends that public charities [501(c)(3)s] continue to be exempt from passive investment income.

INDEPENDENT SECTOR agrees with the Treasury that section 501(c)(3) organizations should remain exempt from tax on their passive investment income. The law has traditionally encouraged charities to place their endowment funds and other investment assets in prudently selected passive holdings of stocks, bonds, and real property. The passive nature of such investments ensures that they will not give rise to unfair competition with for-profit businesses. Indeed, taxing charities on passive investment income would encourage other types of investments that many would regard as less appropriate for charitable organizations. In our view, there is no sound justification for reversing the long-standing policy of encouraging charitable activities through exempting passive investment income.

Royalties

Treasury suggests narrowing the exclusion for royalties by taxing royalties based on net profits and taxing royalties from the use of trade marks and other goodwill. There is no sound reason of tax policy to differentiate between various forms of passive investment as this proposal would. There is no particular reason to make dependence on net profits a touchstone of taxicab. After all, dividends are also in a real sense net profits interests. To the extent the problem to be cured is a concern that purported royalty arrangements are really active exempt organization involvement in business, the answer is clearer standards for differentiating active from passive business.

INDEPENDENT SECTOR cannot support Treasury's further recommendation that the royalty exemption be narrowed to exclude any royalty agreement under which "an exempt organization is exploiting goodwill and other intangibles generated by its exempt purposes." Royalties paid by commercial entities to use an exempt organization's assets cannot, by definition, involve active competition with for-profit business. Indeed, the royalty exemption is a sound way to encourage exempt organizations to leave active management of income-producing business to for-profit business, with the exempt's role being a strictly passive one.

Research

INDEPENDENT SECTOR urges the retention of the current exemption for both basic and applied research carried out by colleges and universities and other research facilities. Research by the higher education community is a long-standing tradition in this country. This vital component of national and international scientific progress assists in economic development, provides valuable information and technology to the business community and remains an integral part of our economy. We accept Treasury's position that a review of the research exception is necessary to distinguish basic and applied research from activity that is purely commercial.

Partnership Allocations

INDEPENDENT SECTOR agrees with Treasury that the tax law should not permit exempt organizations to use partnership investments, or any other device, to trade on their tax-exemption by inappropriately shifting tax deductions and credits to taxable partners. However, we do not believe that Treasury has convincingly established the need for further legislative restrictions in this area at this time. Both the 1984 and 1986 Tax Reform Acts contain provisions directly addressing the problem of allocations between taxable and tax-exempt partners. As the Treasury testimony recognizes, "these rules have significantly reduced the opportunities to shift tax deductions from tax-exempt to taxable partners." While Treasury suggests that a residual problem requires further legislation, Treasury has neither described the problem nor explained what changes in current law should be made to solve it. We believe that Congress should wait for clarification on both points before enacting further legislation in this area.

Chairman Pickle. Thank you for that good and succinct testimony. Now we will ask Joseph O'Neil, chairman of the Business Coalition for Fair Competition, if you will proceed.

STATEMENT OF JOSEPH F. O'NEIL, CHAIRMAN, BUSINESS COALITION FOR FAIR COMPETITION, ACCOMPANIED BY JOHN SATAGAY AND KENTON PADDY, MEMBERS, STEERING COMMITTEE

Mr. O'Neil. Thank you, Mr. Chairman. My name is Joseph O'Neil. I am appearing today as the chairman of the Business Coalition for Fair Competition which I will refer to henceforth as BCFC. Accompanying me today are two members of the coalition's steering committee, John Satagay and Kenton Paddy.

BCFC is a coalition of 29 national trade associations whose members are affected by commercial activity by nonprofit entities.

Last Thursday, Mr. Chairman, a reporter for the Washington Post phoned me. She said she was doing a story about the issue at hand for the Post business section. She asked the standard preliminary questions. Then she paused and asked with a touch of skepticism, "Mr. O'Neil, are these Ways and Means hearings really a big deal?"

Mr. Chairman, in BCFC's opinion, these hearings are indeed a big deal. Their subject presents a big challenge to all of us concerned about it, and the situation we face demands big changes, both in regulations and in approach.

Allow me to elaborate on each of these three points. These hearings are a big deal for a number of reasons. For one, we are talking about big money, more than $300 billion in annual gross revenues for the nonprofit sector.

For another, it has been a long time, 37 years in fact, since the unrelated business income tax was instituted, and this is only the second comprehensive look at how UBIT is working.

Further, during these nearly four decades, there has been dramatic growth. When UBIT was introduced there were 100,000 nonprofit entities. Today there are nearly 900,000.

These hearings are also a big deal because the stakes are high. The business sector most commonly impacted by nonprofit commercial activity is the small business services sector. These are the entrepreneurial businesses that are the driving force of the U.S. economy in the 1980s and beyond. This is the sector that is the greatest source of new jobs, the mother lode of innovation, the fertile field of productivity and efficiency.

Obviously, the nonprofit leadership considers these hearings to be a big deal also. The impressive list of organizations and witnesses on the hearing schedule attests to this fact.

Finally and most importantly, we know that you, Mr. Chairman, and Mr. Rostenkowski, believe this issue of nonprofit commercial activity is a big deal. You have dedicated 5 days of valuable hearing time to them. We commend you for giving attention and prominence to this important public policy issue.

I alluded to a big challenge. Webster defines challenge as, quote, "a summons that is often threatening, provocative, stimulating or inciting." Mr. Chairman, BCFC realizes that in asking this subcommittee, as we will, to recommend major changes in the way government treats the commercial activities of nonprofits, we stretch the word "challenge" to its full meaning.

We do so, however, not out of ignorance of the valued and vital tradition of nonprofit service in our society nor out of any vindictiveness or desire to obstruct the legitimate goals of the vast majority of tax exempt organizations. We do not object to the Girl Scout cookie drive, the Kiwanis citrus sale or the legion of volunteer community projects that are an essential part of U.S. life.

The object of BCFC's concern are gross abuses of nonprofit tax-exempt status. The kinds of enterprise that were aptly characterized, Mr. Chairman, by one of your colleagues on the full committee as nonprofit ducks. "They quack like a profitmaking entity. They waddle like a profitmaking entity." As that gentlemen concluded, so do we. "They should be taxed like a profitmaking entity."

What are these big changes that BCFC proposes? First of all, we suggest a series of steps in the area of data collection. These include requirements for fuller disclosure about nonprofits revenue generating activities, better IRS reporting forms, closer monitoring of nonprofit commercial activity, inclusion of the revenue foregone by tax exemption of nonprofits in the Treasury Department's annual Special Analysis G report to Congress. All of the above are calculated to yield the better data that are so critically important and so badly needed.

Should Congress do nothing until all the data are in hand? Certainly not. We may have glimpsed only the tip of the iceberg. Even that is ample justification for course correction while experts get a better fix on what lies beneath the surface.

In our full testimony, BCFC advances a constructive, reasonable proposal that we believe to be worthy of consideration. Our proposal, in sum, calls for a fundamental change in the way IRS approaches nonprofits' commercial activity.

When a nonprofit conducts a substantial activity on a regular basis in a commercial manner in competition with for-profit firms, IRS should resume that the activity is taxable.

BCFC proposes that this presumption, of course, be rebuttal so that the given nonprofit would have opportunity to justification tax exemption for that activity before IRS could withdraw it.

Thank you, Mr. Chairman, for the opportunity to present the views of BCFC.

[The statement of Joseph F. O'Neil, and a letter received subsequent to the hearing, follow:]

STATEMENT OF JOSEPH O'NEIL, CHAIRMAN, BUSINESS COALITION FOR FAIR COMPETITION

My name is Joseph O'Neil and I am here today on behalf of the Business Coalition for Fair Competition (BCFC). The BCFC is an alliance of trade and professional associations and businesses that share a common concern over the phenomenon known as "unfair competition." The coalition, which was formed in 1983, represents a significant portion of the business community and a wide range of economic activity. A list of BCFC participants is appended to this statement.

The Importance of Nonprofits in Our Society

At the outset, let me make clear what this testimony is not about, and why BCFC believes legislative solutions are needed.

Our purpose is not to denigrate the vital role of nonprofits. The spirit of volunteerism, our ability to balance a system which emphasizes self-reliance with the common welfare of all, is what makes this nation unique. We acknowledge the importance of the independent nonprofit sector and its essential contributions in education, basic research, and charitable endeavors. We are particularly proud of the participation of our small businesses in charitable endeavors. Small business owners serve on the boards of many local nonprofit institutions such as the YMCA, the university, the hospital or the United Way. At the annual pancake festival you will most likely find that the local restaurant owner has contributed the maple syrup. Many nonprofits play a critical role in our society. For example, universities educate the highly trained engineers, scientists and other professionals needed for the jobs of the future. Nonprofit trade and professional associations promote professional and ethical conduct as well as improvements in the quality of goods and services.

Other witnesses may assert that we need more study of nonprofit competition before a legislative solution is appropriate. BCFC cannot accept this argument. Over the past four years, we have participated in many meetings on this issue. These discussions have not produced meaningful reform. It is our assessment that non-legislative solutions are not forthcoming. We come before Congress with the knowledge we have exhausted our options and are no closer to resolving this dilemma.

We have intentionally omitted the presentation of anecdotal case studies in this testimony. In the course of this hearing the Committee will hear from many members of BCFC. These organizations will shed much light on the reality of unfair competition by nonprofits. We will not repeat their stories here. Rather, we hope to provide the conceptual framework for their testimony and to recommend steps to stem the tide of unfair competition. We ask that the Committee consider our testimony and that of our member associations, together, as a whole. It should be noted, also that the General Accounting Office surveyed five of our member associations. The GAO report demonstrates the depth and breadth of the problem and the extent to which the commercial activities of nonprofits have grown.[1]

Unfair Competition by Nonprofits

The problem of unfair competition by nonprofits has rapidly become a top concern of small business. In 1980, the Congress and President Carter sponsored a White House Conference on Small Business. Nearly 2,000 small business owners, elected by their colleagues in local meetings, attended the conference. The delegates reviewed hundreds of proposals and selected 60, 15 of which were identified as immediate priorities. The subject of unfair competition by nonprofits received only cursory recognition and was not included in the top 15.[2] In 1986, a second White House Conference on Small Business was held. This time, one session focused almost entirely on the issue of unfair competition, and the third highest recommendation of the

---

[1] See UNITED STATES GENERAL ACCOUNTING OFFICE, COMPETITION BETWEEN TAXABLE AND TAX-EXEMPT ORGANIZATIONS (1987).

[2] WHITE HOUSE COMMISSION ON SMALL BUSINESS, AMERICA'S SMALL BUSINESS ECONOMY (1980).

Conference called upon government to eliminate unfair competition by nonprofits with small business.[3] As recently as February, 1987, one small business group, the Small Business Legislative Council, reaffirmed the importance of this issue.[4] The fact that the issue has generated such concern suggests that the problem is approaching crisis proportions.

Who are the Nonprofit Competitors?

The first step in an analysis of the problem is to define what is meant by "nonprofit". The term encompasses a wide variety of entities and is commonly associated with the federal tax-exemption (hereinafter references to tax-exempt or tax-exemption refer to the exemption from Federal income tax). For the purposes of unfair competition, tax-exempts and nonprofits are virtually interchangeable terms. However, in theory, the term nonprofit describes a broad classification, of which tax-exempt organizations are but one subgroup. The common denominator of nonprofits is that their charter or articles of incorporation prohibits them from distributing their earnings to any individual or entity that exercises control over the organization.[5] Historically, state laws limited nonprofits to certain purposes. Over time, states have removed this requirement; and, generally, nonprofits may be formed for any lawful purpose.[6] Even the term nonprofit is a misnomer. Distribution of the excess of income over expenses is not, in itself profit. Profit, in its purest sense, is the excess of revenue over expenses; many nonprofits enjoy such excess. Further, preservation and compensation of management or the expansion of capacity can drive profit motive as well as can return on investment.[7] To make a distinction merely on the distribution of earnings diverts attention from the larger issues.

As a practical matter, most significant nonprofits seek an exemption from federal income tax. The Exempt Organization Master File of the Internal Revenue Service listed over 841,000 entities at the end of 1985.[8] These include voluntary and philanthropic organizations such as schools; hospitals; social services; advocacy organizations; civic, social and fraternal organizations; arts and cultural organizations and foundations; religious institutions; and business leagues.[9]

Subchapter F of the Internal Revenue Code (hereinafter Code) includes 25 specific categories of exempt organizations. Nearly half of all tax-exemptions are granted to organizations under the criteria of Code Section 501(c)(3) for religious, charitable, scientific or educational purposes.[10] It is these organizations that generate most of the competition with for-profits. Section 501(c)(3) organizations are generally service oriented, that is they generate revenue by providing services for a fee, and thus are more likely to compete for business. Hospitals and educational organizations account for 36 percent and 17 percent of total tax-exempt revenue, respectively.[11]

---

[3] WHITE HOUSE CONFERENCE ON SMALL BUSINESS, A REPORT TO THE PRESIDENT OF THE UNITED STATES (1986).

[4] SMALL BUSINESS LEGISLATIVE COUNCIL, FINAL REPORT ON THE 1987 ISSUES AND POLICY CONFERENCE (1987).

[5] HANSMANN, The Role of Nonprofit Enterprise, 89 YALE L.J. 835, 838 (1980).

[6] Id. at 839.

[7] Id. at 839.

[8] MCGOVERN, The Changing Character of Exempt Organizations, PHILANTHROPY MONTHLY, April, 1986 at 20.

[9] I.R.C. SECTIONS 501(c)(1)-(25) (1986).

[10] UNITED STATES GENERAL ACCOUNTING OFFICE supra note 1 at 15.

Estimates of the size of the nonprofit, tax-exempt sector range up to $300 billion in income and nearly 9% of Gross National Product.[12] Even the most conservative estimates place it at 3% of GNP.[13] In 1946, the nonprofit share of GNP was 1%.[14] The growth of the nonprofit sector has been nothing short of phenomenal. Additional facts and figures not only place the size of the nonprofit sector in perspective, but also begin to demonstrate why the problem of nonprofit competition has emerged as a critical issue at this time. This information is derived from surveys of the principal organization representing nonprofits, the Independent Sector.

> Overall, the independent sector grew faster than other sectors in the national economy between 1977 and 1982. After 1982, this trend reversed. From 1977 to 1982, the independent sector increased its share of national income from 5.2 percent ($84.4 billion) to 5.8 percent ($155.8 billion). From 1982 to 1984, it share of national income declined to 5.6 percent ($176.3 billion). These figures include the value of volunteer time, which increased from $32.7 billion in 1977 to $74.4 billion in 1984 (2.4 percent of national income).
>
> From 1977 to 1982, the independent sector increased its share of total earnings from work from 6.7 percent ($75.9 billion) to 7.5 percent ($139.2 billion). From 1982 to 1984, its share of total earnings from work declined to 7.2 percent ($157.1 billion). These figures include the value of volunteer time, which increased its share of total earnings from work from 2.6 percent ($29.2 billion) to 3.2 percent ($58.5 billion) between 1977 and 1982. From 1982 to 1984, this share declined slightly to 3.1 percent ($66.5 billion).
>
> From 1977 to 1982, the independent sector increased its share of total employment from 8.6 percent (8.8 million) to 9.7 percent (11.0 million). From 1982 to 1984, its share of total employment declined to 9.5 percent (11.4 million). These figures include volunteer time, which accounted for the equivalent employment of 3.3 million employees in 1977 and 4.7 million employees in 1984. Had estimated volunteer employment not increased nearly 5 percent between 1982 and 1984, the decline in the rate of growth in employment in the independent sector in relation to the rest of the economy would have been more severe.
>
> Employment in the independent sector increased at an annual rate of 3.7 percent from 1972 to 1982, which was much faster than the annual rate of growth for all nonagricultural employees (2.0 percent) during this period. From 1982 to 1984, the annual rate of growth for all nonagricultural employees was 2.7 percent, compared with 1.0 percent in the independent sector.[15]

These figures demonstrate the growth of the independent sector but they do not explain why the sector has grown or identify which tax-exempts are the major sources of unfair competition.

---

[11] Id.

[12] UNITED STATES SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY, CURRENT TOPICS, April, 1985.

[13] HANSMANN, "The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation", 91 YALE L.J. 54,54 (1981).

[14] Id.

[15] INDEPENDENT SECTOR, DIMENSIONS OF THE INDEPENDENT SECTOR, at 3 1987.

The one feature that identifies potential competitors is the source of revenues. Those that derive income primarily from contributions are, by definition, not competitors; those that provide goods or services for a fee have the potential for being competitors. These two types entities are frequently described as donative nonprofits and commercial nonprofits.[16]

What Are The Unfair Advantages?

Unfair competition itself is easy to define, yet difficult to quantify. The unfair advantage is derived from the granting of special status by an external source, almost always the government, which either permits the entity to avoid governmental "burdens" (e.g., taxes) or to obtain direct support (e.g., grants). The exemption from federal taxation is the most significant of these advantages. Others include exemptions from state and local taxes, lower subsidized postal rates, and antitrust exemptions, to name a few.[17] Congress only recently granted another privilege to nonprofits, the ability to obtain contracts from the government on a sole source basis.[18]

Tax-exemption is the most recognized unfair advantage, but it is difficult to measure the extent of that advantage. The Internal Revenue Code includes a provision that requires the nonprofit to pay an unrelated business income tax on activities deemed to be unrelated.[19] Only 22,000 organizations reported any unrelated activity in 1984.[20] Although the income of nonprofits surpassed $300 billion they reported only $27.5 million as unrelated income. Although a lower postal rate or an antitrust exemption is important, there is no doubt that tax-exemption drives the nonprofit issue. It is the linchpin of the nonprofit system.

A significant "benefit" of nonprofit status is the aura of the government imprimatur. While the "aura" has been described as a rationale for the existence of nonprofits,[21] it, in fact, has emerged as a major business advantage. The "contract failure" theory suggests nonprofits assure the public of quality and performance in services for which the consumer is not able to make such judgments.[22] The evidence now suggests that, increasingly, the aura serves as a marketing tool as much as a method of quality control and protection.

The Impact of Unfair Competition

How do these exemptions or privileges provide advantage within the marketplace? The obvious answer is that the exemptions allow the nonprofit to lower the price of the goods or services. A less obvious advantage is the ability to sustain the costs of market entry.[23] The chance to devote more resources to advertising, to produce a better product and to underwrite new products is a tremendous advantage. The National Geographic Society, for example, through nonprofit donations is able to commit vast sums to the production of the magazine, which in turn creates new donors.[24]

---

[16] HANSMANN, supra note 5, at 841.

[17] See COPELAND AND RUDNEY, Business Income of Nonprofits and Competitive Advantage, TAX NOTES, November 24, 1986, See also UNITED STATES SMALL BUSINESS ADMINISTRATION, UNFAIR COMPETITION WITH SMALL BUSINESS, ISSUE ALERT, August, 1986.

[18] COMPETITION IN CONTRACTING ACT OF 1984, PUBLIC LAW 98-369, 98 STAT. 11 88 (1984).

[19] I.R.C. Section 513 (1986).

[20] UNITED STATES GENERAL ACCOUNTING OFFICE, supra note 1, at 22.

[21] See generally HOPKINS, THE LAW OF EXEMPT ORGANIZATIONS, Chapter One (1988).

[22] HANSMANN, supra note 5, at 843.

[23] See ROSE-ACKERMAN, Unfair Competition and Corporate Income Taxation, 34 STANFORD L.R. 1017 (1982).

The damage of unfair competition is difficult to assess because the problem is national in scope, but local in impact. This explains, in part, why the phenomenon hits the small business sector particularly hard. The competition takes place on an institution-by-institution basis. A small business competes against one university or one hospital. The central activity is the provision of service. Service, except for a limited number of franchise operations, does not lend itself to a national marketing strategy. A key index, if one were able to compile the data, is "opportunity lost." How many sales were not made by the for-profit, how many jobs were not created as the result of the sales not made, or the taxes not paid on those sales? In a growing market, if a firm's sales increase 50% but a nonprofit has siphoned off another 50% of the potential growth, how is one to know?

What is clear is that nonprofits have become increasingly reliant on income-producing activities. Contributions as a percentage of income have decreased from 17 to 13 percent, and dues have decreased from 26 to 12 percent between 1946 and 1978. Other income has increased from 57 to 75 percent.[25] The nonprofit sector has gained marketshare, and it is easier to document their gain rather than small business' loss. The correlation is clear, and not surprisingly, the concern of the for-profit business community regarding unfair competition has risen in direct proportion to the increase in the sale of goods and services by nonprofits.

How Nonprofits Compete

Areas in which businesses go head to head with nonprofits include food service, testing laboratories, retail sales of books and computers, travel, recreation, nurseries, day care, hearing aids, veterinarians, blood banks, consulting engineers, medical equipment suppliers, pencil makers, specialty advertisers, hotels, bus operators, printing, construction, laundries, janitorial services, waste hauling, electrical, plumbing and heating contracting to name a few.[26] Many of the members of BCFC have submitted testimony for this hearing. As noted earlier, their testimony will provide the committee with details of how nonprofits compete.

Why Nonprofits Compete

There are two types of competitors. In a number of fields, such as health care, the nonprofit has been dominant provider of the service and it is the for-profit that has sought a foothold in the market. In the second case, the nonprofit has expanded, entering a thriving for-profit market. The reasons for this latter expansion are clear. "Escalating expenses declining revenue and a rising demand for highly technical services have forced many exempt organizations into the commercial arena".[27] More accurately it is escalating expenses, declining revenue, and excess capacity that have forced the exempts to look to the commercial arena. Nonprofits are professionally operated, and sophisticated management will adapt to maximize resources. At the same time, self interest dictates that managers and employees will seek to protect their efforts.[28] The laundry industry provides a classic example.

---

[24] ABRAHAMSON, Geographic Travels Tax-Free, WASHINGTON POST, Sunday, March 8, 1987.

[25] UNITED STATES GENERAL ACCOUNTING OFFICE, supra note 1, at 18.

[26] BUSINESS COALITION FOR FAIR COMPETITION, undated brochure.

[27] MCGOVERN, supra note 8, at 20.

[28] The economic theory known as "Public Choice" lends itself to this issue. JAMES BENNETT, Professor, George Mason University is currently writing a book on the subject.

Nonprofit hospital laundries have learned to capitalize on their resources. Consider the statements of these nonprofit managers: "We intend to turn St. Elizabeth's into a profit making operation." "This guarantees employment for our staff of 32 and allows us to think about hiring more."[29] Meanwhile for-profit laundries have been able to document a corresponding loss of marketshare. One such business owner reports a drop of marketshare from approximately 28-30 percent to 20 percent shortly after the nonprofit laundry expanded its marketing efforts.[30]

The trend towards for-profit performance of activities which have been the province of nonprofits presents an entirely different set of questions. Changes in our society, particularly the growth of health insurance, have created a situation where ability to pay is no longer the dominant factor in determining who receives health care. Either way, there is no organized body of law or economics to explain adequately why nonprofits exist or why governments grant such status to particular enterprises.[31] As early as 1601, the British had conferred preferred status on charitable institutions through the Statues of Uses. In the U.S., the first tax-exemptions surfaced in the Tariff of 1894. Since that time Congress has added over twenty-five specific statutory categories but "not [as] the result of any planned legislative scheme, and [exemptions] have never been set forth as part of any unified concept of exemption".[32]

Academicians have advanced a number of theories to explain the existence of nonprofits. The predominant explanation is the contract failure theory,[33] which states that a consumer "needs an organization that he can trust, and the nonprofit, because of the legal constraints under which it must operate, is likely to serve that function better than its for-profit counterpart."[34] The second theory is the "public goods" theory,[35] which suggests that nonprofits provide services the government would otherwise have to provide to the citizenry. Both the Congress and the courts have provided added credibility to this theory.[36] Small business counters with the assertion that the public good rationale actually begs the question. The existence of for-profits should be prima facie evidence that the government would not have to provide the service. Further, one can ask why the Government does not the subsidize all providers, whether for-profit or nonprofit.[37]

One rationale for tax-exemption is that it fosters volunteerism and the principle of volunteerism is part and parcel of our society and culture.[38] What makes the U.S. economy truly unique is the balance between self reliance and the common good. However, tax-exemption does not have an inherent bearing on the relationship. Nonprofit status without the tax-exemption should foster volunteerism under this theory. The motivation of the volunteer, in addition the desire to contribute to the common good, is the knowledge that no individual will benefit or profit from the work of volunteers. Two commentators have succinctly summed up the common justifications for a tax-exemption and the counter arguments thereto:

---

[29] LAUNDRY NEWS, August, 1983

[30] Letter from David Applebaum to Elizabeth Whittleton (March 9, 1987).

[31] See generally MCGOVERN, supra note 9.

[32] MCGOVERN, supra note 8, at 19.

[33] HANSMANN, supra note 5.

[34] HANSMANN, supra note 5, at 847.

[35] See UNITED STATES SMALL BUSINESS ADMINISTRATION, UNFAIR COMPETITION BY NONPROFIT ORGANIZATIONS WITH SMALL BUSINESS: AN ISSUE FOR THE 1980'S (1984), at 3.

[36] See H. Rep. No 1860, 75 Cong., 3rd Sess. at 19 (1939). See also McGlotten v Connelly, 330 F. Supp 448, 456 (D.D.C. 1972).

[37] See HANSMANN, supra note 14.

[38] See HOPKINS, supra note 22, at 7.

> "**Nonprofits are better suited than for-profits to produce public goods because everyone should have access to public goods at the lowest possible price.** The classic example of a public good is a lighthouse; society is served when all boats use its light. It is very difficult to charge a price for the service because you cannot deny the light to those who do not pay. Some observers think of health care services as this kind of public good. A nonprofit organization, theoretically freed from worrying too much about costs and from raising money, can better deliver such services at the lowest possible price.
>
> This argument confuses funding with production. Government funding underwrites public goods and services that the private marketplace would otherwise not produce in sufficient quantity. The organizational form whose output is most cost effective—whether for-profit, nonprofit, or public—should receive such government funding to produce the needed services.
>
> **Nonprofit organizations have the same motives and rationales—and are subject to the same controls—as public organizations.** But nonprofits are not the same as public organizations because they have few outside controls on their activities. The free market sector is watchdogged by everything from the stock market to government regulatory agencies and consumer advocate organizations. Government institutions have somewhat fewer controls on their performance, like the voting process and bureaucratic budgetary control. Nonprofits have even fewer; boards of trustees appoint their managers who are then subjected to little outside scrutiny. Although some observers believe donors act as a control, in reality they are hardly involved with the impact or results of their donations.
>
> **Nonprofit managers operate from a moral base that makes them more trustworthy than for-profit managers because the mission of their organization is not to made money but to serve society.** Nonprofits are supposedly more worthy to receive private donations than for-profits because their managers will not divert them into the organization's bottom line. Given the weaker controls on nonprofits, however, it is unclear why nonprofit managers should not be equally likely to direct such funds into larger salaries, organizational perquisites, and excessively large staffs.
>
> **Nonprofits are better suited than for-profits to provide services their customers cannot evaluate, such as education or health care, in part because they sacrifice growth to quality.** This argument assumes a naive consumer whose existence we doubt. Given a choice between two organizations that offer the same service, the American customer is more likely than ever to pick the one with the better performance, no matter what its form. More consumers are well-educated today than ever before. Recent sharp declines in deaths from heart disease in the United States, for example, are caused primarily by self-induced changes in life-styles, not from counsel by the medical profession. Further, no one has proven that nonprofits are reluctant to grow; they have tripled since World War II, and their income now represents more than 9% of GNP."[39]

The courts have begun to reexamine the role of nonprofits in our society. A recent case in Utah reveals the extent of this inquiry.[40] The case involves the continuing exemption of a nonprofit hospital under State law.

---

[39] HERZLINGER AND KRASKER, Who Profits from Nonprofits?, HARVARD BUSINESS REVIEW, January-February, 1987, at 93.

[40] Utah City v Intermountain Health Care, 709 P. 2d 265 (Utah 1985).

The court, in dismissing the "public goods" theory, stated,

> "For-profit entities are known, for many reasons, to engage in charity, and nonprofits to withhold it... yet this meeting of a public need by a provision of services cannot be the sole distinguishing characteristic that leads to an automatic property tax-exemption... It may very well be, as a matter of public policy that all hospitals, for-profit and nonprofit, should be granted a tax-exemption because of the great public need they serve... Neither can we find on this record that the burdens of government are substantially lessened as a result of the [nonprofit's] provision of services... Indeed it might be argued that for-profit hospitals relieve a greater portion of the public 'burden' because they provide medical care without public subsidy."[41]

Solutions

The IRS, the nonprofit sector and BCFC agree that the lack of adequate data is part of the problem. In particular, we believe the IRS Form 990 and the Form 990-T fail to identify income in an accurate manner. Form 990 can be improved, particularly in the section dealing with program services rendered. Currently, unless the organization voluntarily submits a 990-T, there is no method to ascertain whether the services could be generating potentially unrelated income.

Consider how effective our current enforcement efforts really are. There are more than 850,000 tax-exempt organizations in the tax-exempt master file. Some 350,000 file the 990 informational return. One of the most common reasons for not filing a 990 is the absence of significant revenue. The threshold for filing is $25,000. Let us grant that there are 500,000 nonprofits under this threshold-mostly small local organizations and chapters run by volunteers. Of the 350,000 that do file a form 990, however, only 27,000 filed 990-T's, reporting unrelated business income. It is the paucity of information about these 300,000 "significant" tax-exempts that is most troublesome. The recently announced IRS Taxpayer Compliance Measurement Program for tax-exempts may be helpful, but it leaves many questions unanswered. The TCMP will review 3,000 of the 990-T's to verify their accuracy. The TCMP does not tell us anything, however, about the 300,000 nonprofits that generated over $25,000 in income but did not file a 990-T. Also consider the fact there are approximately 500 IRS agents assigned to review the nonprofit sector. Common sense suggests it is impossible for them adequately to enforce the law. The IRS itself admits there are no concrete and effective rules for determining the relatedness of income.[42]

The issue of the relatedness test in current law lies at the heart of the unfair competition problem. The Code provides for taxation of revenue of a tax-exempt organization generated from any trade or business the conduct of which is not substantially related to the performance of the entity's tax-exempt purpose (for which it receives an exemption).[43] The experience of small business suggests, first, that the test is virtually impossible to apply and thus impossible to enforce; and, second, that it is not the relevant issue in many cases.

Congress imposed the unrelated business income tax in 1950 in response to the egregious abuse of tax-exemption by nonprofits, of which the Mueller macaroni case was the most famous.[44] Prior to the relatedness test, the destination of the profits rather than the source of the revenue was the measure of taxation.[45] As long as the income was used to further an exempt purpose, the activity generating the income was permissible regardless of its nature. Ironically, the legislative history suggests Congress enacted the test to limit unfair competition.[46] As a practical matter, Congress feared the loss of tax revenue and was disturbed by the trading on the exemption.[47]

---

[41] Utah City v Intermountain Health Care, 709 P.2d 265 277, 278 (Utah, 1985).

[42] See UNITED STATES GENERAL ACCOUNTING OFFICE, supra Note 1.

[43] I.R.C. Section 513.

[44] See C.F. Mueller Co. v Commission, 190 F.2d 120 (3rd Cir. 1951).

It is difficult to define relatedness because, by nature, an entity will expand by utilizing resources that it has on hand and will expand into areas in which it has some expertise.[48] Whether a business is for-profit or nonprofit, sound business judgment dictates such a course of action. As a response to clear-cut abuses such as the macaroni factory case, the unrelated business income tax is an answer. On the whole, however, UBIT fails, because it is difficult to categorize the activities of nonprofits. For example, in an article in a recent edition of The Chronicle for Higher Education, a college official indicated that "the services in question are directly related to the mission of higher education, regardless of whether they compete with the private sector. Selling computers, for example, is directly related to a college's mission because computer instruction would be impossible if students could not afford to purchase equipment."[49] Many businesses would strongly suggest that the relatedness test is not the appropriate test of whether income should be taxed. The relatedness test permits the ends to justify the means. It places a tremendous burden on the IRS and the courts to make a factual determination of motive. The unrelated business income tax has not restrained the growth nor properly taxed the commercial activities of the nonprofit sector.

A more appropriate test would be to determine whether an activity should be granted a tax-exemption in the first instance on the basis of what the activity is rather than what purpose the income serves. What we believe Congress must do is clearly state what are the means by which a nonprofit should achieve its mission. Under current law an organization must be organized and operated "exclusively" for exempt purposes.[50] Although "exclusively" is commonly thought to mean "solely" or "absolutely without exception," the test applied by the courts is to decide whether there is a single non-exempt purpose, substantial in nature. If such a purpose is present, then the entity fails to meet the exclusive test for tax-exemption.[51] The substantial in nature standard falls short of exclusive, and given that the test is a question of fact, many activities have passed the test despite evidence establishing the commercial nature of the activities.[52]

How do we determine whether an activity should be performed by the for-profit sector? Indicia of an inappropriate non-profit activity might be:

1. Presence of substantial profits
2. Method of pricing
3. Competition with commercial enterprises
4. Commercial methods of operation.

---

[45] See Trindad v Sagrada Order, 263 U.S. 578 (1924).

[46] H. Rep. No. 2319, 81st Cong., 2nd Sess., at 36 (1950).

[47] COPELAND AND RUDNEY, supra note 17, at 750.

[48] Id at 751, see also HANSMANN, supra note 13.

[49] Campus Consumer Sales Curb Sought by Small Business, THE CHRONICLE OF HIGHER EDUCATION, February 11, 1987, at 23.

[50] I.R.C. Section 501(c)(3).

[51] Better Business Bureau v United States, 326 U.S. 279, 283 (1945). See also Copyright Clearance Center, Inc. v Commissioner, 79 T.C. 793 (1982).

[52] Presbyterian and Reformed Publishing Co. v. Commissioner, 79 T.C. 1070 (1982), rev'd 743 F.2d 148 (3rd Cir 1984).

Such criteria were articulated by the tax court in the case of Presbyterian & Reformed Publishing Co.[53] The tax court ruling in the case was overturned by the court of appeals[54] which found the tax court exceeded its authority in considering such criteria. The court of appeals indicated that the criteria for judging the appropriateness of the activity must remain "for what purpose was such activity conducted." Nevertheless, the court of appeals acknowledged the difficulty of utilizing this criteria:

> Despite the long history of Section 510(c)(3) and the numerous organizations that have claimed its coverage, no regulation or body of law has defined the concept of "purpose" under this provision of the Tax Code with sufficient clarity to protect against arbitrary, ad hoc decision making... Any explanation of unarticulated or illicit purpose necessarily involves courts in difficult and murky problems. When the legality of an action depends not upon its surface manifestation but upon the undisclosed motivation of the act, similar acts can lead to diametrically opposite legal consequences.[55]

The National Geographic Society, for example, is organized as a nonprofit for educational purposes. The National Geographic Society conducts many activities which are clearly commercial. Among the goods sold by the Society are filmstrips, atlases and books. Although the National Geographic Society has contributed greatly to our understanding of the world, it is difficult to discern where the education and commercial activity begin and end.[56] Commentators have suggested that the unrelated business income test should be abolished because it exacerbates competition by encouraging nonprofits to increase their receipts by taking advantage of the exemption for activities related to their purpose.[57] Many small businesses ask rather why the nonprofit is subsidized if it makes a "profit" (i.e. excess of revenue or expenses) and a sufficient for-profit market exists? The solution, BCFC believes, is to focus on the nature and conduct of the activity rather than on its purpose.

The current presumption is that nonprofits are acting in accordance with their exempt purpose even in their commercial activities. The Presbyterian case exemplifies this presumption. If the presumption had been reversed, the court of appeals, in all likelihood, would have upheld the tax court's decision. We believe the presumption should be reversed. First, if any activity is conducted in a commercial manner, regardless of the purpose, it should be potentially taxable. The factors enumerated in the Presbyterian case are illustrative of commercial behavior. As a common denominator, the presence of "profit", (a substantial excess of revenues over expenses) is indicative of commercial activity. Second, we would allow, in light of the lack of bright line tests in this area, a second criterion that there must exist a for-profit competitive market for the goods and services. A nonprofit hospital may generate an excess of revenues over expenses, but if circumstances make it impossible for for-profits to provide such services, the nonprofit hospital should not be taxed. The definition of competition would have to be flexible and include a "substantial" test. Does one for-profit constitute competition? Most likely a factual determination of substantial competition would be necessary. Among other factors to be considered would be whether the activity is regularly carried on or is an occasional or annual event like the Girl Scout cookie drive. Such occasional activity does not constitute unfair competition. We think that this kind of test would be more meaningful and easier to administer than the current relatedness test.

---

[53] Presbyterian & Reformed Publishing Co., 79 T.C. 1070 (1982).

[54] Presbyterian & Reformed Publishing Co., 743 F.2d 148 (3rd Cir. 1984).

[55] Presbyterian & Reformed Publishing Co., 743 F.2d 148, 156 (3rd Cir. 1984).

[56] ABRAHAMSON, _supra_ note 24.

[57] _See generally_ ROSE-ACKERMANN, _supra_ note 23.

Finally, we would make the test a rebuttable presumption of non-tax-exemption. If the nonprofit, notwithstanding "profit" and "competition", can demonstrate unique, compelling reasons for the tax-exemption, then we would allow for the continuation of the exemption; the nonprofit would have to prove its right to exemption, rather than requiring the public, through the Service, to build a case for why it should not receive an exemption. The purpose of granting flexibility is to permit a nonprofit hospital, for example, to retain tax-exemption if it can distinguish itself on the nature of the services it provides. If the standard is a rebuttable presumption, a nonprofit has the opportunity to make its case to the Internal Revenue Service and the courts. Further, the standard would apply to any or all of its activities. The nonprofit, in effect, would be a bundle of activities rather than a single-purpose organization. One possible statutory scheme to accomplish these goals, albeit imperfect, follows. We welcome the opportunity to work with Congress and the nonprofit sector to refine this preliminary draft.

Section 501(c)(3)
[New language underlined]

(3) Corporations, and any community, fund or foundation, organized and operated exclusively (as defined in Section 501(n)) for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing and distributing of statements), any political campaign on behalf of any candidate for public office.

New Section

501(n) Exclusively means absolutely without exception no single non-exempt purpose exists. A non-exempt purpose will be presumed to exist if any of the activities of the organization

i) produce substantial revenues in excess of the expense for the conduct of such activity, and

ii) compete with entities not exempt under 501(c) unless such activity is conducted by a subsidiary not exempt under this chapter.

What BCFC is proposing is that we look first at "how" an activity is conducted. As one Congressman was quoted as stating during debate on the 1986 Tax Reform Act: "If they quack like a profit-making entity and waddle like a profit-making entity, they should be taxed like a profit-making entity." We cite this quotation in all seriousness because it captures the essence of the problem. In 1987, too many activities of nonprofits have all the characteristics of a commercial venture, but few of the economic responsibilities. The relatedness test relies too much on the judgment of the nonprofit's operators and on criteria that are too subjective. The test we offer today brings nonprofit commercial activities into the light and applies to them the standard by which all competitors in the marketplace are regulated. This test presumes fair competition. We grant the fundamental change in the treatment of "charitable endeavors" that underlies the proposed test, but we believe that many activities (not purposes) of many nonprofits no longer can be characterized as "charitable endeavors." If a charity pays taxes on the revenues of commercial activities and forgoes other nonprofit privileges, such as the lower postal rate, it is still able to use after-tax revenues to support its charitable endeavors.

Another option is a percentage-of-income test. This test would permit the nonprofit to raise a certain amount of revenue from "commercial" activities without taxation. If revenue exceeds the specified percentage or amount, all such income including the first dollar would be considered unrelated and subject to tax. Although this solution has merit, it does not address the basic concerns of small business because it does not preclude unfair competition. It merely limits the amount of activity. For a business competing with a university the amount of the university's allowable commercial revenue may constitute a substantial share of the market.

A final solution is to merely specify a list of unrelated activities. Lists of this nature have been compiled, but as noted earlier, they are outdated the day they are promulgated.[58]

Conclusion

The debate about the proper role of nonprofits and for-profits has only begun. Guaranteeing the availability and quality of needed services is an important concern as is maintaining the spirit of volunteerism. Both the nonprofit and for-profit sectors can point to blatant cases of abuse on the "other side" when an organization has failed to meet its responsibilities. Much as been made of the motives of nonprofits versus those of for-profits. If the issue is, indeed, quality of service, we must argue most strongly that small business has demonstrated that competition ensures a better product at a better price. Both altruism and competition can work to the advantage of the public.

Beneath the surface of this debate are questions regarding the appropriate role of nonprofits in our society and appropriate methods by which to finance those endeavors which Congress and the public deem to be appropriate nonprofit undertakings. The statistics, alone, dramatically demonstrate the expansion of the nonprofit sector and its increased presence in the commercial marketplace. The ever-increasing outcry from small business merely confirms these statistics. The question becomes one of benefits and costs to society and the U.S. economy. The ability of small business to create jobs, to build upon the resources given to it, to innovate, to compete and to push our society and economy towards new horizons is unparalleled. If nonprofits were held to the same marketplace rules when they conduct commercial activities in support of their mission, not only would they become more efficient, we believe they would also become better innovators and job creators. To subsidize their activities at the expense of small business is a double loss.

Reliance on the private sector was a guiding precept for our founding fathers. When ambiguity and doubt begin to obscure the role of government, as it has in the subsidization of the nonprofit sector, we must return to the simple but essential doctrine upon which our economy is founded—reliance on the private sector. Thank you for your consideration, Mr. Chairman.

---

[58] COPELAND AND RUDNEY, supra note 17, at 753.

Business Coalition For FAIR COMPETITION

BCFC PARTICIPANTS - 1987

Alamo II
American Assn. of Nurserymen
American Blood Resources Assn.
American Consulting Engineers Council
American Council of Independent Laboratories
American Orthotic & Prosthetic Assn.
American Society of Travel Agents
American Veterinary Medical Assn.
Arizona Search Consultants Assn.
Assn. of Data Processing Service Organizations
Assn. of Indoor Recreational Facilities of VA
Assn. of Physical Fitness Centers
Bear Creek Corp.
Business Alliance on Government Competition
Chamber of Commerce of U.S.
Fiscal Planning Service
Health Industry Distributors Assn.
Information Industry Assn.
International Communications Industries Assn.
International Racquet Sports Assn.
Kinko's Service Corp.
National Assn. of Chain Drug Stores
National Assn. of Medical Equipment Suppliers
National Assn. of Retail Druggists
National Federation of Independent Business
National Hearing Aid Society
National Office Products Assn.
National Small Business Council for Competitiveness
    in Public Contracting
National Tax Equality Assn.
National Tour Assn.
Professional Services Council
Small Business Legislative Council
Textile Rental Services Assn.
United Bus Owners of America
VEDA Incorporated

1725 K Street, N.W. • Suite 301 • Washington, D.C. 200
(202) 887-58

Business Coalition For
FAIR COMPETITION

July 17, 1987

RECEIVED
JUL 20 1987
Ways and Means
Subcommittee on Oversight

Hon. J. J. Pickle
Chairman
House Ways and Means Subcommittee on Oversight
1105 Cannon HOB
Washington, DC 20515

Dear Mr. Chairman:

The Business Coalition on Fair Competition (BCFC) greatly appreciates the opportunity to have testified before your Subcommittee on the unrelated business income tax (UBIT). We again commend the Subcommittee for the scope and seriousness of its undertaking.

For the record and to support your decisions, we wish to supplement our formal submitted statement with further data which were not available at the time that the testimony was due. Specifically, we call the Subcommittee's attention to the matter of Federal procurement of research and development (R&D) and other services from nonprofit organizations. The attached computer printout has been supplied by CACI's Federal Contract Information Services, known as Pinpoint. In three separate computer tables, for Fiscal Years 1985 and 1986, the printout shows how much Federal procurement of R&D and other services came from large business, small business, and nonprofits, and, most importantly, on what basis -- competitive or non-competitive procurement (enclosure).

Mr. Chairman, the numbers which we summarize here tell a startling story: the Federal Government most often procures services, including R&D, on a competitive basis from business, as indeed it should. However, the government preponderantly procures such services from nonprofits on a noncompetitive basis. Due to such practices, over $6.5 Billion a year in business income comes to nonprofits -- out of taxpayers' pockets -- which is, itself, now scarcely taxed as income. The Coalition, on behalf of its many national constituent associations, submits that this situation calls for correction on both equity and revenue grounds.

Specifically, here are the numbers from page 4 of each of the three tables, with two-year totals for FY85 and FY86 (the percentages do not necessarily total to 100 because of unreported procurement actions):

1725 K Street, N.W. • Suite 301 • Washington, D.C. 20006
(202) 887-5872

Org. Type	Total $ 85-6	Mode	Share
Large Bsns.	$52.6 B	Compet.	49%
	$54.4 B	Noncompet.	51%
Small Bsns.	$23.1 B	Compet.	78%
	$6.2 B	Noncompet.	21%
Nonprofit	$1.9 B	Compet.	12%
	$13.0 B	Noncompet.	86%

Please note several points about this presentation and underlying computer run. First, "competitive" and "noncompetitive" are defined in a standard way. Pinpoint adopted the definitions used by Rear Admiral Stuart Platt, the Navy's Competition Advocate General, for purposes of this analysis (enclosure). We have not defined the terms the way industry might like to see them, but rather in a way acceptable to the government itself.

Second, the sums listed clearly understate the amount of Federal procurement dollars going to nonprofits. For complicated reasons, public universities were not captured in the nonprofit category displayed in the third table of the computer printout. Without doubt, such institutions do sizeable amounts of R&D and other work for the Federal Government, and their inclusion, had it been feasible, would have increased the dollar totals for nonprofits.

Third, The Competition in Contracting Act (CICA) took effect during the two-year period for which data were obtained and analyzed, covering new procurement actions starting April 1, 1985. Ironically, however, the Act is failing to deliver on the promise of its title to the extent that its general exemption from competitive procurement procedures can be used to favor nonprofits (41 U.S.C. Section 253(c)(7), implemented in the Federal Acquisition Regulation at FAR Section 6.302-3). One can already see the effect of the exemption in the nonprofit table, p. 7. In FY85, 33% of all procurement dollars to nonprofits were awarded on a normal full and open competitive basis; in FY86, that number fell to 19%. In other words, matters appear to be getting worse, rather than better, probably due to the unfortunate CICA exemption.

If you have any detailed questions on the interpretation of this printout, Dr. William Schurter of CACI, who prepared it, is available to answer them (876-2137). If the Subcommittee wishes to reprint any part of it for the record, the copyright notice should be preserved, with the legend added, "Reprinted by permission."

Thank you again for your efforts, Mr. Chairman, and the Coalition remains ready to assist you and your staff in any way that we can.

Yours truly,

Joseph O'Neil dyp

Joseph O'Neil
Chairman

Enclosures (2)

(ENCLOSURES RETAINED IN COMMITTEE FILES)

In his opening statement today, Mr. Pickle, Subcommittee Chairman, asked a series of questions that the Business Coalition for Fair Competition (BCFC) wishes to address.

Q. Who is and who should be paying the Unrelated Business Income Tax (UBIT).

It is not easy to know what tax-exempt organizations are paying UBIT, because the 990T forms are confidential information. Available data do suggest that not enough commercial nonprofits are paying the UBIT, however: nonprofits generate more than $300 billion in revenue annually, 75% of which is estimated to be produced by commercial activities - sales of goods and services. Yet, of the nearly 900,000 nonprofit entities, only 22,000 filed a 990T in 1984 - and these relative few reported only $27.5 million as unrelated income tax.

As for who should be paying UBIT, BCFC believes that all tax exempt organizations that engage in commercial activity, that realize a surplus of income over expenses, that operate in a commercial manner, and that provide a good or service that is readily available from tax-paying firms - such tax-exempts should be paying UBIT.

Q. In what types of commercial activities are tax-exempt organizations engaging?

BCFC represents 29 national trade associations, all of which have constituent businesses that face commercial competition from tax-exempt nonprofits. This is our basis for stating that tax-exempts are engaging at least in the following commercial activities: nursery sales (garden type); plasma sales; consulting engineering; applied research and commercial testing and analysis; prosthetic sales; travel services; veterinary services; employment placement services; computer sales and services - hardware and software; health and fitness facilities; health care; medical devices; audio-visual sales; copying and printing services; sales of drugs and pharmaceuticals; hearing aid sales; sales of office products; tour services; business managment and consulting services; and laundry services. We know there are many other areas of unfair competition not yet represented in BCFC. Day care and food and lodging services are examples of this broader universe.

Q. Is the law being administered effectively?

Most emphatically, No. The fact that only $27.5 million was paid in UBIT in 1984 is evidence that it is not. So are a number of tax court decisions, which interpret "substantially related" so liberally as to justify a tax-exempt claiming that almost anything it does or might do is "related" to its mission and, therefore, not subject to UBIT.

Q. Are the application and structure of the UBI tax correct?

Again, No. BCFC believes that UBIT has failed to fulfill its Congressionally-stated purpose: to eliminate unfair competition between tax-exempts and taxable businessess. That is why we propose a new method for achieving the desired fairness and equity. Our proposal is explained in full in our written testimony: Pages 9 to 11. The BCFC recommendation is based on a later-overturned tax court ruling, Presbyterian and Reformed Publishing Co. v. Commissioner, 79 T.C. 1070 (1982). Basically, it establishes a rebuttable presumption that if a tax-exempt operates a commercial business in the competitive marketplace it should be presumed to be taxable.

Q. If the law is deficient, exactly where and how should it be revised?

See previous answer. BCFC believes that the experience of past IRS rulings and tax court decisions is a strong reason for going beyond a mere "tightening" of the relatedness test. We are of the opinion that the relatedness test has failed and should be discarded.

Q. What specific exempt organization activities create the problems?

BCFC is an umbrella group, so the sources of competition faced by its members are quite varied. The two major sources of the unfair competition are educational institutions and healthcare institutions. The educational institutions engage in consulting engineering, commercial research and testing, travel services, tour services, audio-visual and computer sales; they also offer a wide range of office products and bookstore items and compete with at least seven or eight business sectors represented in BCFC. Tax-exempt hospitals sell drugs, pharmaceuticals, hearing aids, medical devices, prosthetic devices, laundry services, and more.

Q. Is the competition issue more a problem of perception than reality.

The competition problem is definitely more than perception. It is real and sizable and serious. Evidence of this is the results of a GAO study of five small business sectors, last year. GAO statistically sampled these sectors: audio-visual firms, health and sports clubs; research and testing firms; tour and travel agents; and veterinarians. Some of the resulting data: 82% of the research and testing firms responded that they face competition from two or more tax-exempt entities. Extrapolating that percentage to the universe of such firms in the U.S. (approximately 4,000) leads to the conclusion that more than 3,000 testing firms are impacted by competition from tax-exempts. One other example - 39 percent of the travel agents indicated competition from more than two tax-exempts. That would mean about 10,000 travel agents face the problem.

Q. Is the problem fundamentally a matter of enforcement and compliance?

It is both of these, but it is, as we have indicated above, fundamentally a problem of an inadequate statute that simply cannot fulfill its purpose, no matter how much it is tightened. In BCFC's opinion, a new approach is needed, because the age of "commercial nonprofits" is upon us.

Q. Have tax-exempt organizations intruded into the for-profit business market? Or, have businesses found a profit in traditional tax-exempt organization activities?

Both have occurred. In the case of competition from educational institutions, the former is the common experience. In the area of competition from health-care entities, there is ample evidence of both phenomena. However, the basic issue should not be: Who was here first? but, rather, can the tax-paying sector meet this need? If it can, why should Government subsidize tax-exempts in this area?

Q. Finally, the basic question. Why is this competition unfair?

It is unfair, because commercial tax-exempts have a set of privileges that constitute a significant business advantage over their for-profit competitors. These privileges include - for most commercial nonprofits: exemption from federal, state and local income taxes; exemption from sales taxes and real estate taxes; lower postal rates; exemptions from some federal regulations; and the "aura of government imprimatur," i.e., that, somehow, because I am a nonprofit, the goods or services I am selling are, ipso facto, better.

xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

Chairman **Pickle**. I will now ask our friend Sheldon Cohen to testify. Mr. Cohen was formerly the Commissioner of the IRS, and we welcome his testimony.

STATEMENT OF SHELDON S. COHEN, CHAIRMAN, ADVISORY PANEL, GRANTS AND CONTRACTS PROJECTS STUDY ON THE ROLE OF NONPROFIT HUMAN SERVICE ORGANIZATIONS, NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS, ACCOMPANIED BY W. HARRISON WELLFORD, COUNSEL

Mr. **Cohen**. Thank you, Mr. Chairman. My name is Sheldon Cohen. I am a partner in the law firm of Morgan, Lewis & Bockius here in Washington, DC. I appear today as the chairman of an advisory committee of the national assembly and the grants and contracts project study. Mr. Harrison Wellford, who is one of the authors of that study, is sitting right behind me.

As you know from our full testimony, the national assembly is made up of 32 of the Nation's largest and best known voluntary service organizations. You have that list. It includes the Boy Scouts, the Girl Scouts, Catholic Charities, the Council of Jewish Federations, Lutheran Council, Red Cross, Salvation Army, United Way and the Y's, and a variety of other organizations that are also included in the contract study.

De Tocqueville's wise observation about the United States almost 150 years ago was that we are constantly forming association. By that he really meant we are doers. We cannot stand to see our fellows suffer and we form charities to relieve their problems.

We did it in de Tocqueville's day long before we thought of having an income tax, and we do it today. By the way, to correct the deputy assistant secretary's comment, there was a tax exemption for charitable orgranizations in 1862 when the tax was enacted to finance the Civil War.

Today we are here to discuss the issue of how charities raise their money to finance what everyone here I believe agrees are worthwhile activities. A few of the more vigorous small business advocates have made charges based on what most of us consider episodic evidence that charities are competing with them.

I do not believe that the general charges today will hold up. There may be some abuses that will turn up, and we ought to deal with those abuses as we see them fully developed.

The dispute is not new. It ebbs and flows with business cycles. At the end of the 19th century when there was a hotel glut, there were complaints about the YMCAs providing safe havens for rural youth who were flocking to the cities in what was then an industrial boom.

Now, we hear the same thing about health clubs. As a personal aside, I suppose the first hotel I ever stayed in was on my first leave from World War II boot camp when I stayed at a Y.

There is a long-standing tax exemption, and its corollary unrelated business tax have worked pretty well. The unrelated business tax was first enacted the year before I came to work for the Internal Revenue Service, and I guess I am responsible for the 69 amendments because I put out a regulation that insisted on fragmentation. So I have had a little history in this area.

I believe that what we need is what Ms. Stathis indicated we need and what Commissioner Gibbs agrees that we have to do. We need more knowledge and we need more vigorous enforcement. I have said that before this committee about a variety of other areas and I will say it about this particular area.

Our human service organizations are almost all local agencies. Their governing boards are local volunteers, and they include, of course, many small business and other business people from the local community.

Fee for service did not come into existence yesterday or last year. It has been around as part of these organizations back to the beginning of time. I was once the president of a social work agency, and we charged our clientele on a sliding scale for counseling, for example.

We might have given them a monetary allowance, and then we would take back at least a dollar for every counseling session. The scale ran everywhere from a dollar to $45 or $50.

Now, that did three things. It raised a small amount of money, but that was not its purpose. It continued to assure low income folks that they got a middle class service and it was good, and it provided dignity.

All those were part of a therapy as well as the therapist time in and of itself. People who pay for things are entitled to first rate service and they will insist on it.

So we have a variety of fee for service. We have visiting nurse associations charging on a per-fee basis. We have the Ys, the Jewish centers receiving a portion of their budgets through fees. We have the Good Will organizations selling refurbished materials.

The data that we have provided you show that in 1984, the last figures for which we have full year availability, government grants were slightly over 43 percent of the total financing of these organizations. Charitable contributions were a little over 37 percent. Fees were only 12 percent. Endowment, miscellaneous accounted for the rest of it.

None of these figures, of course, take into account volunteer time. Our estimates say that if you take in both charitable contributions and volunteer time on a very nominal basis, you would have about 63 percent of all funds coming from that purpose.

Now, it's been stated that fees have risen dramatically. Our data doesn't show that, at least from our organizations. In 1977, the fees were 9.6 percent of total income, and in 1984, they were 12.6. That is hardly a dramatic increase. Now, of course, at the same time from 1981 through 1984 we have a decline of the Federal budget expenditures for the services supported by these organizations of $42 billion.

Concomitant with that, we have had the White House calling on these agencies to redouble their efforts so that the safety net provided by the private sector doesn't fall apart.

Now, Mr. Chairman, my granddaughter will start day care at our synagogue this fall. She will go there rather than to a commercial service which is also available because it provides high quality services that my daughter and my son-in-law want for their child in a religious setting which they feel is important.

Profit at that organization is not the goal but quality of service is. There are for-profit agencies that do a good job, and they are competing with not-for-profits. However, neither one of them is cutting prices. I do not think there has been a demonstration this morning that these people compete on price.

The unrelated business tax was drafted in response to a real problem. As I recall it, there was a macaroni factory around and it works pretty well. I would go along with many of the suggestions that would require more information and more information be made public in terms of the kinds of income and the kinds of activities.

A quick summary of some more of the paper. There was never a golden age when charities did not provide services that business people similarly provided. When the charity proves that the service is desirable, of course, in response to that small business people will go out and provide a service. Who is competing with whom? As I say, charges and fees are not new. They have been around before 1950. If you take a look at the YMCA's data, and we've looked at it, it is about the same percentage of their income today as it was in 1950 when the unrelated business tax was first enacted.

The small business people say that charities are branching out. That is not so except that you might find a few bad cases. And if you do, we ought to deal with them. Again, there is no proof that the prices are being cut. If they are, that might be another indication that you ought to look into it, but we have not seen the data yet.

Episodic information. I can take a machine gun and go out to the lake and fire a hundred shots into it and I might not hit anything. If I did it in the broad light of day and I wanted to hit a fish, I might be able to. I do not know if I can do that with a machine gun but I might be able to do it with a fishing pole. So I think in order to have good public policy, you need good information. We cannot go at it by hunch. I have mine. You have yours. Mr. Gibbs has his. For 200 years, we have been encouraging this kind of activity by these kinds of organizations where everyone in the room, I believe, agrees they do good work.

If there are those aberrational cases where things are going awry, we ought to deal with them either under the existing statute which is probably adequate, but if it is not, then we ought to go at it in a legislative way. But you cannot legislate and hit the target in the dark, and I think we have heard from all the Government witnesses that we are in the dark at the moment.

One more comment, and I do not like to do this, but I am appalled by the SBA's suggestion that we should have private enforcement of the Internal Revenue Code. That is the most appalling thing in the world. What this would mean is that anybody with an enemy can pick his target and use the system to hit at it. We have had those suggestions before and they have been laughed at. Now, here we have a government agency suggesting it, and I think it is silly.

[The statement of Sheldon S. Cohen, and letters and attachments received subsequent to the hearing, follow:]

TESTIMONY OF THE NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH & SOCIAL WELFARE ORGANIZATIONS

Ways & Means Committee
U.S House of Representatives
June 22, 1987

I. Introduction

My name is Sheldon S. Cohen. I chair the Advisory Panel of the National Assembly/Grants and Contracts Project Study on the Role of Nonprofit Human Service Organizations. With me is Harrison Wellford, one of the principal authors of the study.

The National Assembly is an association of national voluntary human service organizations whose members collectively serve over 50 million people each year. The Grants and Contracts Project, which exists to improve governmental administration of grants and contracts with nonprofit health and human service agencies, is made up of 14 national voluntary human service organizations. A membership list for both organizations is attached.

We are here this morning to provide the subcommittee with information about human service nonprofits, what they do, how they are supported and why they have been exempt from federal corporate income tax since 1863. Our testimony reflects some preliminary results of a study of these nonprofits, undertaken with assistance from the Rockefeller Brothers Foundation and the Ford Foundation, which we expect to publish later this summer.

The study will consist of five parts: Part I reviews the rationales for tax exemption of nonprofit organizations as they apply to human service nonprofits; Part II is an historical overview of the origins of human service charities; Part III reviews the development of state law with respect to taxation of the income and property of human service nonprofits; Part IV provides a similar discussion for federal income tax laws, with a particular focus on the development and application of the tax on unrelated business income; finally, Part V covers the operations and sources of revenue of human service nonprofits.

II. The Challenge

Americans have been forming charitable associations since the beginning of the republic. As with education, health care, job training, and even road building and asylums, many of the services we now take for granted from government or commerce originated with groups of volunteers freely associating to solve a social problem or advance a public good. It is the peculiar genius of democracy that it unleashes the energy of individual voluntary activity in both charitable and commercial endeavors.

The tradition of tax exemption for charitable activity is very strong in America. With its roots in Elizabethan England, the recognition that charitable activity both provides important public benefits and reduces the burdens of government crossed the Atlantic with the first British settlers. Property tax exemption for charitable and benevolent activities is guaranteed in virtually every state constitution and, in the few where it is not, is provided for in the state's laws. When the federal government adopted its first corporate income tax to support the Civil War, an exemption was allowed for literary, scientific and charitable organizations. Similar provisions can be found in every federal income tax law enacted since that time.

As de Tocqueville observed, initiatives by private groups of individuals are one of the hallmarks of our national character. "Americans of all ages, all conditions, and all dispositions," he wrote, "constantly form associations." While de Tocqueville saw voluntary associations, acting outside the compulsion of government, as an abiding virtue of a free society, he did not distinguish between commercial and nonprofit activities and, therefore, did not foresee any conflict between them.

Today, however, some of the revenue raising activities of charitable organizations have come under attack by a few small business advocates. Many human service nonprofits which have taken public support for their missions for granted now are being asked to justify tax, postage and other privileges at both the federal and state level. Some small business groups are asking whether the traditional rationales for granting nonprofits tax-exempt status are still valid. They suggest nonprofits should serve only the poor; they question whether nonprofits can receive a majority of their income from fees for goods and services, rather than from donations, and still retain their charitable character, and whether the tax advantages of nonprofits allow them to compete unfairly with for-profit firms selling goods and services in some of the same markets.

This dispute is not new. It tends to ebb and flow with the economic cycles of small business sectors and the shifting fashion of entrepreneurial activity. A hotel glut in New York city at the end of the nineteenth century led to challenges to YMCA residences established to provide a safe haven for rural youth flocking to the cities. When the health and fitness boom of the 1970s tailed off, for-profit fitness spas complained that YMCA exercise facilities had an unfair advantage in competing for members.

The long-standing tradition of tax exemption for nonprofit organizations has served the American people well for over two hundred and fifty years. The millions of people helped each year by human service nonprofits are the principal beneficiaries of tax exemption. While some small business associations have made allegations of unfair competition, little supporting data has been collected. Undoubtedly some abuses exist, but there are existing mechanisms to correct them.

We believe that existing law should be properly enforced, that allegations of unfairness arising from the unrelated business income tax should be properly studied and that Congress should then determine whether existing law should be changed. We have undertaken to educate members of the human services community in their obligations under existing law and we will continue to work with the Internal Revenue Service in this effort. If data collection efforts now underway document the need for tightening any of the unrelated business income rules, we also would be happy to work with the Service on such a project.

III. Definition of human service agencies

Human service providers are those nonprofit organizations that assist the growth and development of individuals and families and help them address crises in their lives. Human service organizations which are discussed in this study include the American Red Cross, Boys Clubs, the Salvation Army, Volunteers of America, Boy Scouts and Girl Scouts, Goodwill Industries, Easter Seal Societies, Family Service agenices, child welfare agencies, Catholic Charities, Jewish Federations, Lutheran Social Service agencies, YMCAs and YWCAs, United Ways and other similar organizations that provide services in every community across America.

Most human service nonprofits are local community organizations. They are governed by local volunteer boards of directors who are drawn from among the members of the community they serve. Nonprofit human service organizations depend on the support of community leaders, including small business executives. They depend on them for volunteers, they depend on them for contributions and they depend on them as a source of goods and services that nonprofits must purchase in order to operate. Businesses, both big and small, also rely on human service nonprofits. Human service agencies may help an employee with a drug problem; they may counsel a troubled family and reduce distraction and absenteeism of employees; they may give training to a disabled person and provide a business with a new and valuable employee.

IV. Fee for service income

The activities of human service agencies which have been questioned by some small business groups by and large are not peripheral services newly created by non-profit "entrepreneurs" to provide an additional source of revenue. Rather, a number of the services being challenged are central to the agencies' charitable missions. The challenge to human service nonprofits is best revealed with illustrations from actual cases:

-- Goodwill Industries, for 85 years, has provided vocational rehabilitation and job placement for disabled people. Its clients generally are individuals who, without Goodwill's services, could not be employed by a for-profit business. In order to provide work experience for its clients, in an atmosphere which advances its training mission, Goodwill provides employment through refurbishing and selling donated articles and through contract services for custodial maintenance, printing, packaging and other activities with skill levels appropriate to their rehabilitation program. Some small business groups claim that Goodwill's tax advantages allow it to underprice and so "unfairly" compete with for-profit businesses offering similar services.

-- Family service agencies provide family counseling to troubled families and individuals. While some family service agency clients can pay for this service, most are from disadvantaged families which must be heavily subsidized. For many years, under contracts with the defense department, family service agencies have provided counseling services to families of servicemen at military bases. Recently, for-profit groups have invoked the small business set-aside program to exclude these agencies from offering counseling services to military families. The result is that family service agencies are denied an opportunity to serve a part of their communities and military families are denied access to a nonprofit service provider.

-- Visiting Nurse Associations provide home health care to the disabled and the elderly. Some of this care is paid for by private funds or government insurance, but some must be subsidized by donations or government funds. When Medicare began to pay for up to 60 days of skilled nursing care at home, the number of for-profit firms providing home health care expanded significantly. These firms now complain that the VNA members compete unfairly with them, even though nonprofit home care providers report that for-profit firms hand off their indigent clients to charitable care when they lose eligibility for Medicare reimbursement.

-- YMCAs and Jewish Community Centers operate multi-purpose facilities which offer a variety of services to the whole family. Some of the members can afford to pay for these services; some cannot. Cash flow from membership fees paid by the more-advantaged members, and from services which attract them, is used to support other services which run at a cash deficit. In a few states, some small business firms engaged in day care and health and fitness services have argued that organizations like these should be taxed on property used for services which may attract customers sought by them.

-- United Way workplace programs offer services, such as free cancer screening or blood pressure testing, to acquaint employees with the voluntary sector's resources. These programs have been criticized by some for-profit firms which offer similar services to corporations for a fee.

V. Fee for service income in perspective

Fee-for-service income is not a radical change in the activity of nonprofits. The collection of fees has been an integral part of the operation of many human service nonprofits for more than 100 years. YMCAs, for example, have always relied on membership fees to support their organizations. Jane Addams' Hull House, established in 1889, opened a book bindery and other businesses to train members of its community in skilled crafts. Jewish organizations established schools and charged fees to those who attended them. Catholic Charities organizations have relied partially on fees for service since the early days of the country.

The majority of agencies which charge fees do so on a sliding scale based on ability to pay. The poor pay little or nothing; the better-off pay proportionally higher fees. Some agencies charge a flat fee, but provide scholarships or other means of financial assistance to those who cannot pay. Some fees may be a token amount. Some agencies simply ask clients to pay what they can.

Paying a fee, when one can, lends dignity, self-respect and self-determination. For some agencies, paying what one can is viewed as an essential part of the help being offered.

Charging fees also enables agencies to serve a broad cross-section of the community. Many who are not poor enough for government assistance are also not prosperous enough to afford the full cost. Nonprofits can provide the help they need.

Serving the whole community assures the poor that they are not being given second-class service. It avoids a two-tier system, one for the poor and one for the better-off. Finally, it can help give better-off members of the community an awareness of community problems and attract their interest as volunteers and their financial support as contributors.

According to data collected by the Independent Sector, the primary sources of support for nonprofit providers of social services are government grants and payments (43.9% in 1984), charitable contributions (37.4% in 1984) and fees for service (12.6% in 1984). 3.3% of social service agency income came from endowment/investment income and the remaining 2.8% from "other."1/

If it were possible to fully account for the value of volunteers' time, the private support received by social service agencies would far exceed any other revenue source. The Salvation Army alone, for example, was served by more than 950,000 volunteers in 1986 who contributed more than 11 million hours of service. Independent Sector estimates that volunteers permitted social services agencies to more than double their total expenditures in 1984. If the value of these services is added to charitable contributions, 63% of the total support for social service agencies in 1984 came from a combination of charitable contributions and volunteering.

The proportion of revenue coming from fees and dues has increased in recent years. In 1977, private payments accounted for 9.6% of funds raised by social service agencies. These payments were 12.6% of total funds raised in 1984, an increase of 3% in their share of total revenue, most of which took place between 1977 and 1982.2/

Aggregate figures do not, of course, provide a complete picture. The relative importance of fees and dues as a source of support varies by organization, by program and even by geographical location. Some human service nonprofits, such as the YMCAs, receive substantial support from fees and dues. But this is not a recent development -- the Y's mix of revenues has not changed over the past thirty-five years.

VI. Impact of Government Funding Cuts

Between 1982 and 1984, federal spending for activities supported by human service nonprofits declined an estimated $42 billion. The funding gap created by this decline has been made up in part by an increase in contributions and volunteering and in part through fee increases. Even with these efforts, the social services sector is experiencing difficulty in generating enough revenue to meet increased demands for its services. One analyst has estimated that private giving would have to grow by about 55% a year just to offset federal budget cuts of 1985 and 1986.[3]

While the White House was cutting the social services budget, it made patriotic appeals to nonprofits to redouble their efforts to provide social services. As a recent report to Goodwill Industries points out, the "government and for-profit business sectors are sending opposite signals to the nonprofit community. On the one hand, the government encourages entrepreneurial activity as a means of improving self-sufficiency; on the other, the for-profits complain of unfair competition when nonprofits engage in entrepreneurial activities designed to promote self sufficiency."[4]

VII. Competition

Many of the areas in which human service agencies are being challenged are areas of service which were pioneered by nonprofit organizations. The Salvation Army and Volunteers of America, for example, pioneered the development of comprehensive treatment for drug and alcohol abusers. Family service agencies and visiting nurse associations created the concept of home health care delivery. YMCAs were encouraging physical fitness for one hundred years before the advent of Manhattan's Vertical Club or Holiday Health Spas.

Competition between nonprofits and for-profits is a fact of life in the co-existence of the sectors. Nonprofits cannot exist and should not be asked to exist without some reliance on fee-for-service income. A healthy voluntary sector with the confidence to experiment and offer a wide range of services to the community as a whole requires some stability in its income base; fees for service are an essential part of this stability. Even when they serve people who are part of a for-profit's "market", nonprofits often can demonstrate attributes of accessibility (both in cost and location), stability, and trust which distinguish them from the competition.

There are fundamental differences in the motivations of for-profit businesses and nonprofit organizations in offering similar services. Goodwill Industries, for example, provides assistance to the disabled by training them in real jobs; to accomplish this purpose it may engage in providing janitorial services, but the provision of those services is distinctly secondary to its primary mission of educating and training. A nonprofit day care provider has as its fundamental purpose the provision of quality day care. A for-profit day care provider also may offer quality day care, but its primary motivation is, as it should be, the generation of profit for its shareholders.

VIII. UBIT and Administration

The fundamental purpose of the unrelated business income tax was to prevent unfair competition between nonprofit organizations and businesses. However, the unfairness that concerned Congress in 1950 was competition in areas of purely commercial activity, such as operating a noodle factory, which did nothing to carry out the organization's charitable purpose. Congress did not intend to tax, or otherwise restrain, exempt activities, even if they competed with commercial sources. The drafters of the unrelated business income tax, like the drafters of the basic exemption provisions, recognized that there are areas where businesses and nonprofits offer similar services; the concept of "relatedness" ensured that activities furthering the exempt purposes of the nonprofit would remain tax exempt.

The drafters of the unrelated business income tax recognized that applying the relatedness test would not always be simple. As Rep. Lynch pointed out in debate:

> It is not possible to define in the bill exactly every case that is going to be covered. We have drawn it so that there is a certain amount of discretion for the determination of questions of fact as to whether or not a certain matter comes within the purview of the bill.[5]

Charitable activities are continually evolving in response to community needs. Recognizing this, most courts have adopted a definition of charity that also is capable of evolving to meet new needs. The concept of relatedness fits well with this definition of charitable in that it allows both the Internal Revenue Service and the courts the flexibility they need to examine an activity in the context of the entire scope of a charity's services.

In reviewing the unrelated business income tax in light of modern complaints of unfair competition, the Committee will ask three questions: what is the extent of competition between small business and nonprofits? Is the competition fair? If it is not fair, do the benefits contributed by nonprofits to public good as a result of this activity outweigh the losses, if any, to the commercial sector?

If in investigating these questions, the Committee looks at a particular fee-for-service activity of a nonprofit in isolation and compares it to commercial activity of similar form, it risks missing the point of what nonprofit human services are all about. It makes no more sense to view Goodwill Industries as a second hand clothing store, or the Girl Scouts as a cookie direct sales organization, than it does to view the Marines as an outward bound school or the Chicago Bears as a dance and rap video act.

Nonprofits are living, breathing entities that ought not be artifically dismembered to examine a few services out of the context of the whole. The Committee should look first to whether the organizations are fulfilling their charitable mission and only then examine the agencies' funding sources. If it does this, it is more likely to make balanced judgements about the competition issue.

IX. Common Misunderstandings About Nonprofit Human Service Organizations

Some small business advocates have suggested that any income generating activity by a nonprofit should be taxed if a profit-making business offers a similar service. Underlying this suggestion are several persistent myths about nonprofit human service organizations.

Myth One -- The Golden Age

We have encountered a belief that there was once a golden age of charity when services were provided free of cost using funds acquired through contributions. As we have discussed, this has never been the case. Human service charities always have relied on a combination of government funding, private contributions, membership dues and fees for services rendered.

Nonprofit human service agencies, like nonprofit museums, hospitals and universities, serve more than just the poor. They serve many individuals who fall in the gray area between poverty and the ability to pay the full cost of a service. Nonprofits serve people in need: single parents, Vietnam veterans, people with AIDS, drug and alcohol abusers, all of whom may be in need of human services regardless of their income.

Myth Two -- Charging Fees Is a New and Rapidly Growing Source of Revenue for Nonprofits

While fee income is growing for some human service nonprofits, it remains a relatively small proportion of total income for social service agencies as a group. As noted, private payments to social service agencies were 12.6% of their income in 1984. Some organizations do rely heavily on fee income. However, this is not necessarily a recent change. YMCA's for example receive the same percentage of their income from fees and dues today as they did in 1950.

Myth Three -- Charities Are Aggressively Branching Out into the World of Business

This is not the case for most human service nonprofits. In fact, many complaints of unfair competition occur not because nonprofits are opening a new business or offering a new activity but because businesses are seeking to expand operations in areas traditionally served by nonprofit organizations.

Myth Four -- Competition by Tax Exempt Organizations Is "Unfair"

There is no evidence that tax exemption allows nonprofits to compete "unfairly." The two advantages most frequently cited by small business advocates are that tax exemption permits nonprofits to charge lower prices and that tax exemption permits nonprofits to accumulate income free of tax for use in expanding their activities.

To the extent that costs, and therefore fees, are less because of tax exemption, tax exemption helps nonprofits carry out their mission. If a service, such as family counseling, costs less because of tax exemption, a greater number of people will be able to benefit from it. This benefit to the community must be weighed against the impact, if any, on for-profit firms' ability to attract additional customers.

Accumulation of surplus, tax free, also is not a form of unfair competition because the surplus, and any capital assets it is used to acquire, must be dedicated to a public purpose. Again, the primary question is not whether a nonprofit has a relative advantage vis a vis a business person but whether the nonprofit is using the surplus to carry on an activity that the tax code seeks to encourage.

Myth Five -- There Is a Clear-cut Distinction between Commercial and Noncommercial Services

Certain small business advocates argue that nonprofit organizations can be neatly divided into those that are "commercial," i.e. those that rely on income from the sales of goods and services, and those that are "donative," i.e. those that rely on contributions and volunteer services. This dichotomy does not reflect the real world.[6]

Human service nonprofits receive income from a variety of sources including donations, government grants, fees and sales of goods. Taxing "commercial" nonprofits either would mean taxing virtually all nonprofits or would require a tedious service-by-service, market-by-market comparison of nonprofit services with those of for-profit organizations that would make the current application of the fragmentation rule to museum shop sales appear a miracle of simplicity. Moreover, lacking the thirty-seven years of precedent that has grown up around the relatedness test, such a test would set the stage for new and complex litigation over the meaning of "commerciality."

The most important reason not to adopt the test of commerciality, however, is that it turns on its head nearly four hundred years of common-law and legislative precedent. The test for tax exemption always has been whether the aims and goals of the charity provide a public benefit and whether the charity's assets are devoted to accomplising those goals.

X. Public Policy Supports Tax Exemption for Nonprofits

Nonprofit organizations have been exempt since the very beginning of the federal corporate income tax. They are exempt because they provide important public benefits to the community as a whole and because they reduce burdens the government otherwise would have to incur. Governments traditionally have refrained from taxing the income and property of nonprofits for reasons that are as sound today as they were at the time of Elizabeth I.

A fundamental rationale for tax exemption for nonprofits is that they provide a variety of goods and services that would not otherwise be supplied either in adequate quality or quantity. There are areas in which a purely market economy is deficient in supplying goods and services because it is impossible to charge those who benefit a price that equals their value, in this case because they benefit society as well as the individual. A teenager cured of drug addiction, for example, receives an immediate benefit, but the community as a whole also benefits. The same is true throughout the spectrum of nonprofit services from day care to nursing homes.

Government also refrains from taxing the income of nonprofit organizations to encourage the growth and development of voluntary associations among its citizens. Voluntary organizations offer an alternative to both the government and the private market that encourages trust among the recipients of its services. Because so many of the services are highly personal in nature, consumers may prefer a provider who is motivated primarily by generosity and altruism. Many people may prefer a specific religious and cultural setting: one family may choose day care at a Jewish Community Center, another may seek counseling under the auspices of Catholic Charities, a third may choose to join the YMCA because it has programs for all members of the family and offers goals beyond simple physical fitness. An individual with a disability may seek assistance from an organization staffed with fellow sufferers who instinctively understand and sympathize with the problem. Tax exemption helps keep these choices available to all.

Nonprofit organizations also engender trust because of the standards they enforce. In many cases, standards first internally adopted by nonprofit service providers have become the norm for the community as a whole. The Council on Accreditation, an independent body organized by human service nonprofits, requires periodic accreditation of its members to assure they are maintaining professional standards.

Nonprofits strengthen their communities by providing a mechanism through which local people can solve local problems through voluntary action. Nonprofit human service organizations are governed by community-based boards of neighbors. Local control allows for greater flexibility and responsiveness in meeting community needs.

Nonprofits have a commitment to their communities to provide services in good times and bad, whether they are profitable or not. The track record of many human service nonprofits underscores their role as reliable providers of human services. Tax exemption helps ensure that communities will not be deprived of vital services if the vagaries of the market or shifts in government policy reduce or eliminate the ability to make a profit.

Nonprofits have been a fertile source of creative solutions to community problems. Because their motivation is contributing to the public good, and not a healthy balance sheet for the next quarter, they have greater flexibility to experiment with new programs and approaches to relieving social problems. Meals on wheels, treatment for alcoholics and drug abusers, workshops for the blind and severely handicapped, community blood-banks, visiting nurses, even basketball and volleyball -- the human service landscape is fertile with the innovation of nonprofits, many of which have subsequently been adopted by government and for-profit corporations. Tax exemption helps assure that nonprofits will be able to continue this tradition of creative problem-solving.

Tax exemption has been a spring-board for mobilizing the donations and volunteer services that make services available with far less government support than would otherwise be required. The Salvation Army, for example, spends more than the entire federal government on alcohol and drug abuse treatment. Nonprofits spend $1 billion more a year on rehabilitation services than federal and state governments combined. The millions of hours of volunteer services provided free of charge are an important community resource. If nonprofits did not offer these services, either the government would have to pay for them or people would go without help they need.

Nonprofits also have been schools for citizenship and nurseries for leadership. Many volunteers, who got their first taste of community service through hours devoted to a local charity's board of directors, go on to community service as a whole. Nonprofits help build bridges between generations and classes within a community, fostering a community tolerance and unity.

XI. Conclusion

We do not have reliable information that would enable us to estimate the extent to which human service organizations engage in taxable unrelated business activities. However, we believe the number is small. Catholic Charities, for example, reports unrelated business income was 0.3% of the total income of its organizations in 91 reporting dioceses. Family Service America had only 0.9% of its income in a category called "other." It is possible that some small fraction of this 0.9% was unrelated business income; it is equally possible that none was.

We do recognize our obligation to inform and educate human service organizations about their duty of compliance with the unrelated business income tax. As an initial step in this direction, the Grants and Contracts Project prepared a manual on compliance with UBIT. GCP members are providing this manual to their members and encouraging them to review their conformance with the law.

Members of the Grants and Contracts Project also have met with business representatives on several occasions to discuss the problem of competition. We believe that many of the complaints of "unfair" competition can be resolved if nonprofits and businesses are willing to sit down at the local level and discuss their mutual problems. We are encouraging our local affiliates to do so.

Footnotes

---

[1] Data collected by Independent Sector are for SIC Code 83, "social services." This includes individual and family services, job training and related services, child day care services, residential care and social services not elsewhere classified. Dimensions of the Independent Sector, Table 4.6 at 124 (1986). While social services are the bulk of services provided, human service nonprofits also offer some health care services including nursing home and long-term health care. These latter services are more heavily dependent on fees. United Way estimates that on average its member agencies receive 21.9% of income from fees for services and dues, 41.2% from government grants and contracts, 23.6% from their own fund-raising efforts and United Way and 13.3% from "other" which includes investment income from endowment funds, foundation grants and sales of goods.

[2] Dimensions of the Independent Sector, Table 4.2 at 119-120 (1986).

[3] A. Abramson & L. Salamon, The Nonprofit Sector and the New Federal Budget, 87-89 (Urban Institute, 1986).

[4] Santa Fe Corp., Evaluating the Issue of Alleged Unfair Business Competition between Goodwill Industries and the For-Profit Commercial Sector, 4 (April, 1987).

[5] 96 Cong. Rec. 9367-68 (1950).

[6] The author of the distinction, Henry Hansmann, recognized this difficulty. He offered the terms to describe "polar or ideal types rather than mutually exclusive and exhaustive categories" to further his academic analysis. The Role of Nonprofit Enterprise, 89 Yale L.J. 835, 841 (1980). Regrettably, this cautionary language of Professor Hansmann has been ignored as the "commercial/donative" distinction has been offered as the basis for legislation.

Members of the Grants & Contracts Project

American Red Cross

Boys Clubs of America

Boy Scouts of America

Catholic Charities USA

Child Welfare League of America

Council of Jewish Federations, Inc.

Family Service America

Goodwill Industries of America, Inc.

Lutheran Social Services System

The Salvation Army

United Way of America

Volunteers of America

YMCA of the U.S.A.

YWCA of the U.S.A., National Board

THE NATIONAL ASSEMBLY
OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS, INC

1319 F Street, N.W. • Suite 601 • Washington, D.C. 20004 • (202) 347-2080

ADVISORY PANEL ON THE ROLE OF NONPROFIT HUMAN SERVICE ORGANIZATIONS

Judge Sharon Bell
Chancellor
Chancery Court Part III
City and County Building
Main Street
Knoxville, TN 37902

Paul Berger, Esquire
Arnold & Porter
1200 New Hampshire Avenue, N.W.
Washington, D.C. 20036

Philip Bernstein
320 Central Park West
Apartment 14G
New York, NY 10025

Joyce M. Black
200 East 66th Street
Apartment E-502
New York, NY 10021

Leonard A. Blackshear
President
Associated Enterprises, Inc.
120 Admiral Cockran Drive
Annapolis, MD 21401

Lisle C. Carter, Jr., Esquire
Verner, Liipfert, Bernhard, McPherson & Hand
1660 L Street, N.W.
Washington, D.C. 20036

Sheldon S. Cohen, Esquire (Chair of Advisory Panel)
Morgan, Lewis & Bockius
1800 M Street, N.W., Suite 600
North Lobby
Washington, D.C. 20036

AFL-CIO, Department of
Community Services
American Association of Homes
for the Aging
American Camping Association
American Red Cross
The Association of Junior Leagues
Big Brothers/Big Sisters of America
Boy Scouts of America
Boys Clubs of America
Camp Fire
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations
Family Service America
Future Homemakers of America
Girl Scouts of the U.S.A.
Girls Clubs of America
Goodwill Industries of America
Lutheran Council in the USA,
Division of Mission and Ministry
National Council of Negro Women
The National Council on
the Aging
The National Network of Runaway
and Youth Services
The Salvation Army
Travelers Aid Association
of America
Travelers Aid International
United Neighborhood Centers
of America
United Seamen's Service
USO (United Service Organizations)
United Way of America
VOLUNTEER-The National Center
YMCA of the USA
YWCA of the U.S.A., National Board

THE NATIONAL ASSEMBLY
OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS, INC.

1319 F Street, N.W. • Suite 601 • Washington, D.C. 20004 • (202) 347-2080

THE NATIONAL ASSEMBLY
of National Voluntary Health and Social Welfare Organizations

MEMBERS

AFL-CIO, Department of Community Services
American Association of Homes for the Aging
American Camping Association
American Red Cross
The Association of Junior Leagues
Big Brothers/Big Sisters of America
Boy Scouts of America
Boys Clubs of America
Camp Fire, Inc.
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations
Family Service America
Future Homemakers of America
Girl Scouts of the U.S.A.
Girls Clubs of America
Goodwill Industries of America
Lutheran Council in the USA,
  Division of Mission and Ministry
National Council of Negro Women
The National Council on the Aging
The National Network of Runaway and
  Youth Services
The Salvation Army
Travelers Aid Association of America
Travelers Aid International
United Neighborhood Centers of America
United Seamen's Service
United Way of America
USO
VOLUNTEER: The National Center
Volunteers of America
YMCA of the USA
YWCA of the U.S.A., National Board

AFL-CIO, Department of
  Community Services
American Association of Homes
  for the Aging
American Camping Association
American Red Cross
The Association of Junior Leagues
Big Brothers/Big Sisters of America
Boy Scouts of America
Boys Clubs of America
Camp Fire
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations
Family Service America
Future Homemakers of America
Girl Scouts of the U.S.A.
Girls Clubs of America
Goodwill Industries of America
Lutheran Council in the USA,
  Division of Mission and Ministry
National Council of Negro Women
The National Council on
  the Aging
The National Network of Runaway
  and Youth Services
The Salvation Army
Travelers Aid Association
  of America
Travelers Aid International
United Neighborhood Centers
  of America
United Seamen's Service
USO (United Service Organizations)
United Way of America
VOLUNTEER-The National Center
YMCA of the USA
YWCA of the U.S.A., National Board

Douglas J. Dayton
Dade, Inc.
400 Shelard Plaza South
Suite 205
Minneapolis, MN 55426

Marian Wright Edelman
President
Children's Defense Fund
122 C Street, N.W.
Suite 400
Washington, D.C. 20001

George M. Elsey
5351 MacArthur Boulevard, N.W.
Washington, D.C. 20016

Dr. Joseph L. Fisher
Special Assistant to the President
George Mason University
4400 University Drive
Fairfax, VA 22030

The Rev. Thomas J. Harvey
Executive Director
Catholic Charities USA
1319 F Street, N.W., 4th Floor
Washington, D.C. 20004

James Johnson, Director
Government Affairs
Apple Computers
1892 Preston White Drive
Reston, VA 22091

The Honorable Robert T. Matsui
2419 Rayburn House Office Building
Washington, D.C. 20515

The Honorable George Romney
1840 East Valley Road
Bloomfield Hills, MI 48013

Dr. Lester M. Salamon
Institute for Policy Studies
Johns Hopkins University
Shriver Hall
Baltimore, MD 21218

Ida Schmertz
Senior Vice President
Corporate Affairs and Communications
American Express Corporation
American Express Tower
World Financial Center
200 Vesey Street, 47th Floor
New York, NY 10285-4305

Vincent R. Sombrotto
President
National Association of Letter Carriers
100 Indiana Avenue, N.W.
Washington, D.C. 20001

WELLFORD, WEGMAN & HOFF
1775 PENNSYLVANIA AVENUE, N.W.
SUITE 450
WASHINGTON, D.C. 20006
(202) 775-0200

RICHARD A. WEGMAN PAUL S. HOFF
HARRISON WELLFORD THOMAS H. STANTON
JOHN L. SACHS JANNE G. GALLAGHER

June 26, 1987

Hon. J.J. Pickle, Chairman
Oversight Subcommittee
House Committee on Ways and Means
1105 Longworth House Office Bldg.
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Pickle:

Sheldon Cohen has asked me to respond to Rusty Geritz' request for additional information concerning both unrelated business income earned by human service organizations and sources of income that are exempt from the tax on unrelated business income. The information we are able to provide is largely anecdotal due to the difficulties of collecting data from the 37,000 plus local independent organizations our members' represent. However, I think that it will give you a fair idea of the general sources of revenue with which you are concerned and of their relative magnitude. Human service organizations still to testify today and Monday will be able to provide more detailed information for their affiliates. Further, as we gather more information, I will be happy to keep your staff apprised of what we learn.

Summarizing the enclosed statement: the facts available suggest that human service organizations earn insignificant amounts of unrelated business income. For the one organization with complete data, unrelated income equalled .05% of the organization's total income. We would be surprised if unrelated income of any other organization exceeded this amount.

Many organizations have no unrelated income at all. For those who do, the main source of unrelated income appears to be rental of debt-financed property -- either because of excess space in an office building owned and partially used by the organization or as a result of property acquired through bequest or gift. We also have found instances where unrelated income was earned from sales of advertising (two cases), one laundry facility, one small "coffee garden," and one instance of sale of goods manufactured in a rehabilitation facility. Organizations reporting this type of income either filed Form 990T or, if the activity was carried on in a subsidiary corporation, the appropriate corporate tax returns.

Although we have not documented specific instances, other possible areas where unrelated income could be earned by human service organizations would include gift shops if merchandise is unrelated and the shop is not substantially operated by volunteers, and parking lots, cafeterias and travel and tour services if they are open to the general public and not substantially related to the organization's exempt purpose. Certain of the examples reported to us also raise the possibility that a few organizations which reported filing Form 990T may not have been required to do so.

Human service organizations also derive a portion of their total income from fees for program services. This income is, for reasons discussed in Mr. Cohen's testimony, substantially related to the organizations' exempt purpose and so is not subject to the tax on unrelated business income. Overall, social service providers received $2.7 billion in fees from private sources, representing 12.6% of their total income in 1984. This figure would be somewhat higher if payments through Medicare/Medicaid were included. Fees are generally charged on a sliding scale based on ability to pay or scholarships are provided.

Some organizations, particularly the Salvation Army, Goodwill Industries and Volunteers of America, receive substantial support from the sale of donated merchandise. Goodwill Industries, for example, derives more than half its support from these sales. Sales of donated merchandise are exempt under § 513(a)(3) and may also be exempt as related if the sales contribute importantly to the organization's basic rehabilitation function. Treasury has not recommended changing this exemption.

Finally, for a few organizations, small amounts of revenue are received from sales of related merchandise in gift shops, from cafeterias and vending machines operated

Hon. J.J. Pickle
June 26, 1987
Page 3

for the convenience of the members, and from a few travel and tour programs offered to members. The amounts involved are so small that, as in the case of unrelated business income, they are not separately reported. Depending on the facts, the activity may be exempt as related, may be exempt because it is carried on substantially by volunteers, or may be exempt because it is for the convenience of the members.

I hope that this information is helpful to the Committee and I will continue to supply any additional material we receive. The enclosed study contains a more detailed analysis of the revenue sources of human service organizations and the difficulties they are experiencing as a result of declining federal support.

Sincerely,

Harrison Wellford

H. Harrison Wellford

Enclosure

Members of the Grants & Contracts Project

American Red Cross
Boys Clubs of America
Boy Scouts of America
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations, Inc.
Family Service America
Goodwill Industries of America, Inc.
Lutheran Social Services System
The Salvation Army
United Way of America
Volunteers of America
YMCA of the U.S.A.
YWCA of the U.S.A., National Board

NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS SUPPLEMENTAL STATEMENT

Ways and Means Committee
U.S. House of Representatives
June 26, 1987

At the June 22, 1987 hearing on the unrelated business income tax, various members of the Oversight Subcommittee expressed concern that despite the growth in the number of nonprofit organizations since 1968, relatively few nonprofits file Form 990T. This supplemental statement will address three issues: i) reasons for the growth in the number of nonprofit organizations, ii) the general incidence of unrelated business income among human service organizations*/ and iii) the activities carried on by those organizations which produce income that is related to the organizations' exempt purpose or otherwise exempt or excluded from the unrelated business income tax. Attached to this paper is a working draft of the chapter of the forthcoming National Assembly's study that explains in greater detail the income and services of nonprofit human service organizations.

Size of the Nonprofit Community

Deputy Assistant Secretary Chapoton testified on Monday that the number of nonprofit organizations had grown substantially, from about 410,000 in 1968 to about 866,000 currently. Although, as former IRS Commissioner Sheldon S. Cohen pointed out in his testimony on behalf of the Assembly on June 22, the statistics for 1968 are highly questionable since prior to 1969 there was no reqirement that new nonprofit organizations seek approval by the IRS of their exempt status, nevertheless the number of nonprofit organizations has grown and is continuing to grow.

---

*/ A list of the members of the Grants & Contracts Project is attached.

We believe this growth shows that the nonprofit sector continues to be a vital force in American society. As new needs have been identified over the past twenty years, new organizations have sprung up to meet them. The Civil Rights movement, the growth in immigration of people of Hispanic and Oriental descent, the women's movement, the environmental movement, the aftermath of the Vietnam war -- all have led to the formation of new nonprofit human service organizations to meet needs not widely recognized before 1968. The number of soup kitchens and food pantries in New York City alone has grown from 30 to almost 500 in the past seven years. Services to the homeless and to persons with AIDS, homes for runaways, Meals on Wheels, spousal abuse shelters, child abuse programs, rape crisis centers, displaced homemaker services -- all are examples of new programs or programs that have substantially increased in size in the last twenty years.

The growth in the number of nonprofit organizations also reflects growth in population and in the economy as a whole. Businesses also have grown in number during this period. As the attached chart reflects, during the period from 1977 to 1984, the number of independent sector organizations grew about 10%, from about 740,000 to about 820,000. During the same period, the number of businesses grew about 19%, from about 14.7 million to about 18.1 million.

Number of Nonprofits with Unrelated Business Income

It is not surprising that a relatively small number of the total number of § 501(c)(3) organizations file Form 990T. First, a large number of these organizations, probably well over half, have annual incomes of less than $25,000 and so are not required even to file Form 990. In fact, as IRS has reported, the number of § 501(c)(3) organizations required to file Form 990 actually declined between 1975 and 1982 despite the overall growth in the total number of organizations. IRS attributed this decline to an increase from $10,000 to $25,000 in the floor below which filing is not required, indicating both that a large number of nonprofits are very small and that increases in the overall number of organizations will not necessarily lead to increases in the number of Forms 990, or presumably the number of Forms 990T, filed. (Heuchan, Nonprofit Charitable Organizations, 1982, SOI Bulletin, 21 (Winter, 1985-1986). An organization with gross annual income of less than $25,000 is unlikely to be engaged in earning unrelated business income; it is far more likely to be out soliciting the money needed to keep its doors open.

In fact, although there are a large number of nonprofit organizations, the assets of the nonprofit community are concentrated in a relatively small number of organizations. Of the approximately 76,000 § 501(c)(3) organizations required to file Form 990 in 1982, less than one in five had assets of $1 million or more. 6% of all nonprofit organizations controlled 81% of the assets and for the most part these are either hospitals or schools. It seems reasonable to assume that the organizations with the largest asset bases are those most likely to have significant amounts of unrelated business income, but the number of such organizations, and thus the number of potential filers, is relatively small.

Answering the committee's specific question regarding revenues collected from unrelated business activity and taxes paid is difficult. Human service nonprofits are generally local community organizations. They are individually incorporated, have their own Boards of Directors and file their own tax returns. Members of the Grants and Contracts Project estimate that they represent about 37,000 such local organizations. National organizations do not, however, except as noted, control local organizations and cannot require responses to specific data requests.

Unrelated business income is such a small portion of total revenue for nonprofit human service organizations that it has never been separately reported by these local affiliates. Typically, data reported, as in the case of data identified in the Assembly's testimony, has focused on major sources of support: contributions, fees from program services, government payments and endowment/investment income. As the Assembly's testimony noted, in 1984 social service providers derived revenues from:

government grants and payments	43.9%
charitable contributions	37.4%
fees for services	12.6%
endowment/investment income	3.3%
other	2.8%

Revenues characterized as "other" include bequests, sales of goods (including sales of donated merchandise), special fund-raising events, foundation grants, and sale of capital assets. To the extent that unrelated income is earned, it is probably included either in "other" or in endowment/investment income.

Members of the Grants and Contracts Project have been able to gather the following information concerning activities carried on by their affiliates which earn income subject to the tax on unrelated business. Overall, there is relatively little such activity, the income generated is small, and the tax paid is often minimal.

Three organizations, the Salvation Army, the Volunteers of America and the American Red Cross either control their local affiliates directly, or report for them under a group exemption letter, and so have complete information concerning activities which earn unrelated income. Of these, the Salvation Army and VOA both report that they earn no unrelated business income and so do not file Form 990T. The Red Cross reports that approximately .05% of its total revenues are derived from unrelated business activities, primarily rental of debt-financed property. These organizations also report that they have not established for-profit subsidiaries to carry on unrelated business activities.

Organizations whose local affilates file their own tax returns also generally report no, or very limited, unrelated business activity. YMCA of the USA, for example, recently surveyed 20 of its local affiliates and found that only one ever derived income from an unrelated business: operation of a debt-financed parking lot which ceased in 1977.

Goodwill Industries of America reports that it knows of no affiliates with unrelated business income and no affiliates with for-profit subsidiaries. Boys Clubs of America similarly knows of no affilates with unrelated business income or for-profit subsidiaries.

Catholic Charities reports only one local affiliate, out of 91 reporting dioceses, with unrelated business income. This income was derived from rental of three office buildings bequeathed to the agency during the period of time that it took the local Catholic Charities to dispose of them.

The Lutheran Social Services System reports two local affiliates with unrelated business income: one from sale of products manufactured in the course of a rehabilitation program and one from operation of a laundry conducted through a for-profit subsidiary.

The Council of Jewish Federations surveyed 17 large city Jewish Federations and 33 large-intermediate city Jewish Federations. Two of the 17 large city federations, and four of the 33 large-intermediate city federations, filed Form 990Ts in 1986. Again, the primary activity appears to have been rental of property although some Federations had unrelated income from oil and gas leases as well. Two Federations publish newspapers and derive unrelated business income from sale of advertising.

Family Service America had three local affiliates which filed Form 990T. Two of them involved rentals of debt-financed property. One operated a "coffee garden" which, while partially staffed by volunteers, has sufficient paid staff that it did not qualify for exemption from the unrelated business income tax.

Because the data we have are incomplete and because of the number and diversity of local affiliates, it is possible that other affiliates do earn unrelated business income. Besides income from debt-financed property, unrelated income may be earned from parking lot operations, sales of unrelated merchandise in gift shops not staffed primarily by volunteers, and cafeteria and vending machine operations as well as travel and tour operations, if they are open to the general public. The amounts of income earned are likely to be quite small.

Related Income

As discussed more fully in our testimony, human service organizations do earn income from fees for services they provide that are substantially related to the organization's exempt purpose. Fees either are based on a sliding-scale, depending on the ability of the client to pay, or provided free to those who cannot afford to pay. Although fees may be collected, most such services are not self-supporting; they require subsidization through volunteer efforts and contributions. To illustrate, the Salvation Army provides meals for 1700 senior citizens in one of its programs in San Francisco. It charges $1.25 for a meal costing $4.50 to provide and makes up the difference through contributions and volunteer help. Those who cannot afford to pay even $1.25 are given free meals.

It is impossible to provide a complete list of services offered by all 37,000 local affiliates, in the course of carrying out their exempt activities, for which a fee may be charged. Red Cross alone, for example, catalogs more than 1400 different service programs, in addition to a core set of services, offered by one or more of its local chapters. Many are free, but there may be a charge for others. Overall, according to data reported by Independent Sector, social service providers derived approximately $2.7 billion from private payments for services in 1984. They received an additional $9.4 billion in government payments some of which were reimbursements through Medicare/Medicaid for services. Contributions totalled $8 billion and endowment/investment income was $700 million. With $600 million in "other" income, the total revenues of social service providers in 1984 were about $21.4 billion.

Following is a list of some of the general types of services for which fees may be charged. Again, the fees charged are related to the client's ability to pay, or ways are found to assure that those who cannot pay receive services. Many of these services also may be supported by government programs. The list includes, but by no means is limited to, day care, family counseling, family life education, home health care, visiting nurse programs, adoption services, nursing home care, camping, adult education and cultural programs, youth activities, immigration amnesty counseling, testing and rehabilitation services for the hearing-impaired, Meals on Wheels, day care for the elderly, employee counseling, homemaker services, financial credit counseling, and transportation services for the elderly and disabled and in rural communities. Some human service agencies have participated in the construction of housing for the elderly and disabled under § 202 of the Federal Housing Act. Rents, based on the ability of the tenant to pay, are charged for these apartments. Rehabilitation services for persons with disabilities are provided free to the recipient but are supported, in part, by fees paid by government agencies. Refugee resettlement programs similarly are supported, in part, by government payments.

As we pointed out in our testimony, these services are directly and importantly related to the purposes for which the organizations providing them have been granted exemption from federal income taxation. Some of these services also may be offered by for-profit organizations to those who can afford to pay the market price. Both the charging of fees, and the existence of alternative proprietary sources of these services, are matters of historical fact predating enactment of the unrelated business income tax in 1950.

The relatedness test was designed to distinguish activities society wished to recognize by tax exemption from those that it did not. As both Treasury and the Internal Revenue Service pointed out, it remains a good test. Introducing competition as a factor, as some of Monday's witnesses suggested, would, for reasons discussed in the Assembly's testimony, substantially confuse the question of determining which activities should be tax exempt.

Affiliates of some organizations, principally Goodwill, the Salvation Army, and Volunteers of America, generate substantial revenues from the sale of donated merchandise, primarily through their thrift shops. Unusable donated merchandise is sold for salvage. These sales are exempt from the unrelated business income tax under § 513(a)(3). In addition, thrift shop operations may be directly related to the exempt purpose for which these organizations were formed since individuals being provided rehabilitation services often are employed throughout the process of receiving donated goods, preparing them for sale and selling them.

Affiliates of some organizations maintain gift shops which sell merchandise related to the organization's exempt purpose. Some Jewish Community Centers, for example, may sell Judaica to their members. YMCAs sell to their members athletic clothing and sports equipment associated with Y programs. Some organizations, YWCAs for example, may occasionally offer a travel program or tour to their members. Many local affiliates may sell T-shirts bearing the affiliate's name. Sales may be exempt either because they are related to the organization's exempt purpose, because they occur sporadically or infrequently, and so are not a trade or business, or because they occur in shops staffed primarily by volunteers.

Treasury Recommendations

Deputy Assistant Secretary Chapoton outlined seven areas involving the unrelated business income tax which he felt deserved further investigation. We agree that these areas should be explored. Without doubt, Form 990 and/or

Form 1023 could be improved to provide everyone with more usable data with respect to the income sources of nonprofit organizations. We hope, however, that this improvement would be accompanied by a commitment on the part of the Internal Revenue Service to tabulate and publish the data, in usable fashion, not merely collect it.

The volunteer exception and the convenience exception both merit further investigation. Human service organizations, in general, probably make more use of the former than of the latter, particularly in connection with fund-raising activities. We tend to believe that the constraint that the activity be carried on substantially by volunteers provides an inherent limitation on the size and scope of the activity, but we would be happy to discuss with Treasury whether there are abuses (we are not aware of any) which merit a limitation on the exemption.

Increasing the floor below which unrelated income need not be reported makes sense, although, as noted, most human service nonprofits seem to have little unrelated income. Treasury also has suggested changing the rules with respect to characterizing subsidiaries as controlled. From the limited data we have been able to collect, human service nonprofits appear to make little use of for-profit subsidiaries. Other organizations may be in a better position to comment on this suggestion of Treasury.

Human service organizations generally would not be affected by the remaining Treasury Department recommendations except that they sometimes participate in partnerships for the construction of low-income housing. We would be happy to consider and comment on any specific proposal in this area as well.

WELLFORD, WEGMAN & HOFF
1775 PENNSYLVANIA AVENUE, N.W.
SUITE 450
WASHINGTON, D.C. 20006
(202) 775-0380

RICHARD A. WEGMAN
HARRISON WELLFORD
JOHN L. SACHS

PAUL B. HOFF
THOMAS H. STANTON
JANNE G. GALLAGHER

RECEIVED
JUL 16 1987
Ways and Means
Subcommittee on Oversight

July 16, 1987

Hon. J.J. Pickle, Chairman
Oversight Subcommittee
House Committee on Ways and Means
1105 Longworth House Office Bldg.
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Pickle:

On June 26, 1987 we supplied information to the committee about the unrelated business income earned by affiliates of members of the Grants and Contracts Project. This letter includes information about affiliates' income which is specifically excluded or exempt from the unrelated business income tax and also comments on the recommendations of the Department of Treasury. Some GCP members, including YMCA of the USA, Red Cross, United Way of America and Goodwill Industries of America, will supply data to you directly.

RELIANCE OF GCP MEMBERS ON UBIT EXCLUSIONS

As described in greater detail in the National Assembly's testimony and in the June 26 submission, most human service agencies receive the bulk of their income from three sources: charitable contributions, government grants and fees for services directly related to their exempt purposes. Income which is exempt from taxation because of one of the UBIT exemptions or exclusions generally is not a large part of total income.

Sales of Donated Merchandise

As reported in our earlier letter, local affiliates of some members of the Grants and Contracts Project, principally Goodwill Industries, the Salvation Army, and Volunteers of America, rely on sales of donated merchandise for a significant part of their total revenues. These sales are exempt from the tax on unrelated business income under § 513(a)(3). In addition, thrift shop operations may be directly related to the exempt purpose for which the organizations were formed since individuals being provided rehabilitation services are employed throughout the process of receiving donated goods, preparing them for sale and selling them.

Passive Income

Next in order of importance is the exemption afforded by § 512(b)(1) for passive income: interest, dividends, rents, and royalties. Thus, local affiliates of Family Service America reported receiving approximately $10.5 million (4.2% of total income) in 1985 from income earned on investments. Presumably nearly all of this would be income that is exempt by virtue of § 512(b)(1). Similarly, 76 of 119 reporting Catholic Charities agencies had investment income totalling $14.4 million (2.6% of total income) in 1985 from investments. Local YMCAs reported $23.2 million in investment income for 2.5% of total 1986 revenue.

Convenience of Members, etc.

YMCAS report receiving about $10.2 million, or 1% of their income, from food service operations. This income is attributable to the snack bars and lunch rooms operated by some local YMCAs for the convenience of their members and therefore exempt under § 513(a)(2). YMCAs also receive $17.6 million, or 1.7% of total income, from sales of publications and other program materials and from sales to members and program participants of racquet balls, swimming goggles, and similar athletic equipment directly related to Y fitness programs. Much of this sales activity, especially sales of program materials, would qualify as related without regard to the convenience doctrine.

We have not been able to determine other instances of reliance on the convenience doctrine; however, some local affilates of other GCP members may make use of this exception for activities such as employee cafeterias and sales to members.

Activities Carried on by Volunteers

We do not have data concerning the extent to which affiliates of members of the Grants and Contracts Project rely on the exception in § 513(a)(1) for income from a trade or business in which substantially all the work is performed without compensation. However, we believe that this exception may be of importance to some local organizations which use volunteers to operate small gift shops or other regularly carried on fund-raising activities.

As you know, the information we possess is limited and the spectrum of human service organizations is broad. However, we hope that the information we are able to supply responds to questions you and others raised at the hearings.

EFFORTS TO IMPROVE DATA COLLECTION

While many of our organizations collect basic program and financial data annually from local affiliates, these surveys have focused on major sources of income (contributions, government payments and fees for directly related services), populations served, types of services rendered and other areas that do not coincide with some of the questions raised by the subcommittee such as use of the UBIT exclusions. More extensive data have not previously been collected partly because the types of income with which the committee is concerned are generally a very small part of human service agency budgets and partly because complaints of unfair competition had not generally been directed at human service agencies except in isolated instances.

In response to the Committee's press release announcing these hearings, the Grants and Contracts Project developed a questionnaire for local affiliates on unrelated business income (copy attached). Initial attempts at using the form, however, have produced results that were often internally conflicting, making tabulation impossible. This illustrates the basic need for educational efforts, especially among smaller organizations, concerning the unrelated business income tax.

Accordingly, United Way of America is taking steps to establish a program which will use local United Ways to educate local United Way funded agencies on their obligations under the unrelated business income tax and to collect data of the type requested by the committee. This effort will make use of a paper produced by the Grants and Contracts Project explaining the unrelated business income tax rules (copy attached) and the survey instrument. We welcome any suggestions the committee or your staff may have on either the survey instrument or the education effort. We will share additional data with the committee when it is available.

On July 7, 1987, the chief executives of the seventeen major United Way funded agencies met and discussed the gaps in data identified at the hearings. These executives committed their agencies to examine ways to improve data collection in these areas and to implement improved data collection systems. This will ensure that data of the types requested by the committee are collected systematically in the future.

COMMENTS ON TREASURY RECOMMENDATIONS

With the foregoing as background, we would now like to respond more formally to the Treasury recommendations. Treasury has, we believe, done an excellent job of identifying the major issue areas raised by the unrelated business income tax. We agree that all these areas deserve further investigation and some may require legislative or regulatory change. We also agree that the floor below which unrelated business income need not be reported should be increased to $5,000.

Data Collection

Data on income-producing activities could, and should, be collected in a more systematic way. As noted, the chief executives of seventeen major human service charities already have committed their agencies to improvements in data collection efforts. We also support revisions to Form 990 to improve the way in which the IRS collects these data. Mr. Jacob's suggestion, that Form 990 be revised to indicate the exemptions relied upon for various sources of income, could be a way to collect this data expeditiously and in a usable form. We also think that organizations should be required to report affiliated and subordinate corporations, along with the tax status of each organization.

Volunteer Exception

Excepting activities carried on substantially by volunteers supports the importance of volunteerism in American life. It seems to us that the requirement that substantially all the work be performed without compensation limits the extent to which such a business could be carried on. If there are examples of abusive situations, we would be happy to work with IRS on regulatory language to curb the abuse.

Convenience Exception

Based on limited data, the convenience exception appears not to be widely used by nonprofit human service organizations. Organizations making more substantial use of this exception thus would be in a better position to comment on whether it should be changed and how that change should be effected.

Donated Property

Sales of donated property are an important source of support for some human service agencies and one which has not been a source of controversy. We agree with Treasury that the exception covering these sales should not be changed.

Allocation of Expenses

We think that expense allocation rules should be clearly spelled out. However, because the data we have been able to gather indicate that human service organizations are not extensively engaged in unrelated business activities, other organizations should be better able to comment on the policy choices underlying the allocation rules and what the substantive content of those rules should be.

Controlled Subsidiaries

As noted in our earlier letter, we have been able to identify, thus far, only three instances in which GCP affiliates have used a subsidiary in connection with an unrelated activity. It would be helpful, especially for smaller nonprofits, if IRS spelled out clearly, in regulations or revenue rulings, procedures and rules governing the establishment and use of subsidiary profit-making corporations. Rules now inferred from GCMs and private letter rulings would be more accessible and more authoritative if they were formally promulgated.

There may be instances where the activities of a subsidiary should be attributed to its parent in assessing whether the parent is operated primarily for an exempt purpose. Generally this should occur only where the directors and executives of the parent are substantially involved in the day to day operations of the subsidiary and the parent is not maintaining a charitable program that is commensurate in scope with its resources. Again, however, other organizations making more extensive use of subsidiaries are in a better position to comment on this issue, as well as on whether the control test should be changed. If changes are made in existing law, organizations should be given a period of time within which to adapt their operations to the new requirements.

Passive Investment Income

We agree with Treasury that the net investment income of § 501(c)(3) organizations should remain tax exempt. For human service organizations lucky enough to possess an endowment, this income is a small but important source of stable revenue that can be tapped to meet unexpected needs or to experiment with innovative programs. For the most part, investment income is either the product of charitable contributions by donors who have restricted use of the principal or represents earnings on funds held for use later in the charity's fiscal year (many charities rely heavily on annual fund-raising appeals; the funds thus collected are held in interest-bearing accounts until disbursed for a charitable purpose). It would be particularly inappropriate to tax income from contributions which are themselves tax deductible.

As the Joint Committee staff noted in presenting the arguments against taxing endowment income, investment income has been exempt since the inception of federal taxation; the revenues of nonprofit organizations lessen the burden of government or otherwise promote the general well-being of communities; and, imposing the tax on nonprofits would indirectly tax the recipients of the charity's benefits such as the poor, the elderly, and the disabled. These arguments support Treasury's recommendation to continue to exclude investment income from taxation.

Royalty Exclusion

Our limited data indicate that GCP affiliates do not rely heavily on the royalty exclusion although a few may have oil or gas leases as part of their endowment. Some human service organizations, however, do receive income from advertising or promotional efforts of private businesses (as in the case of support to the Statue of Liberty Foundation by American Express) in which the business agrees to contribute a fixed sum to the charity for each product purchased or service used in a given period. We do not think that the contributions derived from these promotional efforts are the type of royalty income with which Treasury has expressed a concern. Accordingly, we hope that if there are changes to the royalty rules, they will not inadvertently deprive charities of this source of income nor deprive corporations of this way of supporting private sector initiatives.

Research Activities

GCP affiliates, to the best of our knowledge, are not engaged in research except that which is plainly related to their exempt purposes -- an organization may, for example, measure the effectiveness of a particular program or activity in achieving its purposes. Again, to the best of our knowledge, research is either supported by other organizational income or by government grants and is generally made available to the public.

Joint Ventures and Partnerships

We do not think that joint ventures and partnerships should automatically be treated as unrelated without regard to the structure of the relationship and the goals it seeks to achieve. In this regard, we have one overriding concern in the partnership area. We recommend that any changes in the current rules governing partnerships should be crafted to avoid any further diminution in the incentives to produce housing for low-income, elderly and disabled individuals. Partnerships have been an important mechanism to raise the capital needed to construct this housing. We think that § 501(c)(3) organizations should continue to be allowed to participate, with appropriate safeguards to ensure that the charity's obligations as a partner do not overwhelm its obligations as an exempt organization, as general partners in the development of housing for these groups. We think that IRS rules governing housing partnership activities should incorporate some of the safeguarding factors suggested in private letter rulings in the area.

The Relatedness Test

Neither Treasury nor the Internal Revenue Service recommended changing the basic relatedness test and we agree. It is clear, even from our limited data, that the change discussed at the hearing that would most deeply affect nonprofit human service organizations would be a change in the relatedness test.

Two basic suggestions for change have been offered: one is that a test of "competitiveness" be substituted for relatedness in determining whether an activity should be accorded exempt status. The other is that "commercial" activities of nonprofits should be taxed.

Adopting either of these tests might result in subjecting many of the activities of human service nonprofits to taxation. As explained in the testimony of the National Assembly, human service nonprofits traditionally have charged fees for services they provide and many of the services they offer have a for-profit counterpart. The competitiveness test would require IRS to undertake market analyses to determine whether a nonprofit is competing with a for-profit and whether that competition is "unfair." The result would be that whether an activity was properly exempt would depend on the ebb and flow of business cycles and trends rather than on the needs of the community. As many witnesses suggested, a test depending on the existence of competition would be unreliable, impracticable and impossible to enforce.

The commerciality test would simply tax all non-donative income of nonprofits, a proposal so far-reaching that even its author suggested it needed extensive study. Charging a fee does not, of itself, automatically render a service "commercial." When fees are charged, they are based on a sliding scale or other financial assistance is offered to those who cannot afford to pay. Charging fees enables agencies to serve a broad cross-section of the community, not just the poor, and paying a fee lends a measure of dignity and self-respect. If the charging of a fee becomes the sole basis for distinguishing between an exempt service and a non-exempt service, we would abandon more than one hundred years of operations of human service charities, in which fees have been charged, and the more than one hundred years of exemption from federal income tax laws these charities have been afforded.

We agree with Treasury and IRS that the application of the relatedness standard may pose interpretive difficulties in some areas. We think that IRS can and should determine, through its audit function, whether the activities of exempt organizations are in furtherance of an exempt purpose. As IRS makes determinations that affect general types of activities, it should publish those determinations in revenue rulings or in regulations so that they are readily accessible to all.

We would be happy to meet with IRS to discuss specific problem areas and to work out appropriate regulatory solutions. Should you or your staff need any further data, or if discussing these issues would be helpful to you, we would be pleased to cooperate further.

Sincerely,

W. Harrison Wellford

W. Harrison Wellford
Counsel to the Grants and
Contracts Project

Attachments

Participating Organizations

American Red Cross
Catholic Charities USA
Council of Jewish Federations, Inc.
Family Service America
Goodwill Industries of America, Inc.
Lutheran Social Services System
National Board, YWCA of the U.S.A.
The Salvation Army
United Way of America
YMCA of the U.S.A.

[Attachments Retained in Committee Files]

Chairman PICKLE. Now, we will be glad to receive testimony from John Motley, director of government affairs for the National Federation of Independent Business. Mr. Motley.

STATEMENT OF JOHN J. MOTLEY III, DIRECTOR OF FEDERAL GOVERNMENT AFFAIRS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, ACCOMPANIED BY ABRAHAM SCHNEIER, LEGISLATIVE REPRESENTATIVE

Mr. MOTLEY. Thank you, Mr. Chairman. It is a pleasure to be here today, and joining me, behind me, is NFIB's tax counsel, Mr. Abe Schneier.

I have a rather lengthy testimony which I have submitted to the committee and I would like to summarize it if I can at this point in time.

First of all, I would like to thank you and the chairman of the full committee, and the rest of the members of the committee, for holding these hearings on what is obviously a very difficult subject, and for responding to the concerns expressed by the small business community last August in the White House Conference on Small Business.

NFIB is very concerned about what we consider to be an explosion in the size and the scope of the commercial activities of nonprofit organizations.

Today's nonprofit organization is likely to be a multitiered, multimillion dollar organization with several subsidies. Or subsidiaries, excuse me. Subsidies, also.

I think all we really would have to do is just to take a look at some of the more obvious cases, such as the National Geographic, the AARP, the one that has been in the news recently, the PTL, and yes, even in FIB to see that this is indeed true. We are definitely multimillion dollar organizations with many, many different subsidiaries.

According to the GAO report that was released earlier this year, in 1975, only 39 percent of the funds raised by 501(c)(3) tax-exempt organizations were from business receipts.

In 1982, 81 percent, more than double the amount raised in 1975 of those revenues came from the same business-related sources. For 501(c)(4) groups, 51 percent of their revenues were generated from program services.

In brief, Mr. Chairman, we at NFIB are concerned about three things. First of all, that current law does indeed give nonprofits a competitive advantage in the marketplace where they choose to compete with for-profit businesses.

No. 2. That it allows the tax dollars being paid by our members, and other small businessmen and women across the country, to be used to subsidize activities in competition with them, and no small business owner enjoys that.

And No. 3. That it reduces the tax base which is available, which of course puts a great deal of pressure on all of those small businesses out there who are paying taxes, day in and day out, year in and year out, to help meet the bills of the Federal Government, and government at all levels.

Because of this, NFIB has some serious concerns about the operation of the unrelated business income tax, sections of the Internal Revenue Code, as they relate to the issues of competition from nonprofit organizations with smaller businesses.

Let me give you some examples, if I can, Mr. Chairman, just a few because there are many, of the types of competitive advantages that we believe that nonprofit organizations have in the marketplace.

First of all there is the most important one which is the exemption from the Federal income tax laws, and it is very important because, as Frank Swain stated here before, it really leads to a whole list of other benefits, subsidies and exemptions that are available to these nonprofit organizations. The next being exemption from State and local property taxes; exempt from State sales taxes.

In the case of universities, exemption from FICA taxes. Tax-subsidized financing, either by the deduction which is given to contributors to these organizations, or by a more direct method, and that is tax-exempt bonds.

Labor market advantages, and again, not only are nonprofits able to attract both volunteers and low-wage employees who are dedicated to what they are doing, but in some cases, such as universities, again, they do not have to pay payroll taxes which, for my members, represents the largest single tax that they pay.

And last, but certainly not least, Mr. Chairman, there is what we would all call the halo effect which is out there, and that is a general belief amongst the public that nonprofit organizations are doing things for the greater good of society as a whole, and for no other purpose, and for-profit organizations are not.

Chairman PICKLE. What do you call that?

Mr. MOTLEY. The halo effect, Mr. Chairman.

Chairman PICKLE. Halo.

Mr. MOTLEY. Since competition from nonprofits was voted as the number three recommendation or concern of the White House Conference on Small Business last summer, NFIB has been tying to communicate with its members across the country to try and get their input into the problems that they are experiencing in this area, and we have developed a log of more than 300 complaints or cases from our members, which, if the committee wishes, we will be more than happy to share with you.

But the purpose in mentioning that here today is because in those cases, as they came in, there seems to be a common thread of common complaints or concerns which are being voiced by the members that have either called us, or written to us.

I would like to share with you, Mr. Chairman, six of these areas, of six of these common threads which tend to go through our correspondence.

The first is the failure of the UBIT statute to give clear guidance in defining related and unrelated activities. Second, the practice of captive referrals and tie-ins between nonprofit organizations and their for-profit subsidiaries.

Third is the financing of nonprofit subsidiaries, or the financing of for-profit subsidiaries by their nonprofit parents.

Fourth, cost allocation rules which we think are extremely difficult and give nonprofits a tremendous advantage. Fifth, postal subsidies, and last, providing services or products to the general public as a whole, and more to the general public, as a whole, than they provide to the populations that they originally targeted to get their nonprofit exemption.

Mr. Chairman, NFIB believes that central to a workable solution is a carefully crafted revision of the UBIT statute and IRS sections 501 and 511 through 514.

That, one, makes as clear a distinction as possible between related and unrelated activities, two, provides guidelines of minimum standards devised for an organization to qualify as tax-exempt.

Three, establishes some limitation to ensure that the nonprofit treats noncontributed income as unrelated income, and/or limit the amount of noncontributed-income tax that can be declared related income.

Another approach, Mr. Chairman, could be to consider establishing an arms-length standard for transactions between a nonprofit and its for-profit subsidiaries.

And a third suggestion that we might make for the committee to take a look at is for you to consider requiring a nonprofit to file an application with the IRS to receive a predetermination on whether a proposed activity is related, or unrelated, before such an activity is begun.

Revision of the statute should be accompanied by strong enforcement including increased IRS audit coverage, and revisions in the form 990 and 990–T. In concluding, Mr. Chairman, I simply cannot let the remarks by one of the other panelists go, as terms that "there's no competition out there in price", as far as he sees it, between nonprofit and for-profit organizations.

I have read a number of letters that come in from NFIB members, have talked to a number around the country, who are, indeed, experiencing strong price competition from nonprofit organizations. Particularly, I think, all you have to do is take a look at pharmacies in this country and who they are competing against, whether it be nonprofit hospitals, unions, the AARP, Mr. Chairman, that you know very, very well, and I think there are just numbers of other cases.

I am sure one of the other witnesses up here on the panel, Mr. Hess, who is going to testify last, can give you some examples of the problems that he has run into with price competition dealing with the university community.

Thank you very much, Mr. Chairman. I will try to answer any questions you might have, or provide any additional information that the committee might desire.

[The statement of Mr. Motley and subsequent submissions follow:]

STATEMENT OF
JOHN J. MOTLEY III

DIRECTOR OF FEDERAL GOVERNMENT AFFAIRS

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	HOUSE WAYS & MEANS COMMITTEE, SUBCOMMITTEE ON OVERSIGHT
Subject:	NON-PROFIT COMPETITION AND THE UNRELATED BUSINESS INCOME TAX PROVISIONS OF THE INTERNAL REVENUE CODE
Date:	JUNE 5, 1987

Mr. Chairman, on behalf of the more than one half million small business owners who are members of the National Federation of Independent Business (NFIB), I am pleased to be appearing before you today to discuss the issue of the operation of the Unrelated Business Income Tax (UBIT) sections of the Internal Revenue Code (IRC) as it relates to the issue of competition from non-profit organizations with small businesses.

Mr. Chairman, I congratulate you, this Subcommittee, and Congressman Rostenkowski, Chairman of the Ways and Means Committee, for committing to these hearings. The hearings explore a subject that many would rather not deal with, a problem for which there are no quick answers, but which demands attention and thoughtful crafting of solutions.

You will hear both from organizations that promote the general welfare and from organizations that promote economic independence and are the backbone of our free enterprise system. We hope that you and the other members of the Committee will consider the comments of the small business community carefully.

The issue of unfair competition with nonprofits was ranked third in a list of 60 recommendations developed at the 1986 White House Conference on Small Business. The concern is that our complex system of government subsidies provide certain organizations with tax and non-tax benefits which go far beyond original congressional intent, and the combination of these tax and non-tax subsidies makes fair competition impossible.

This is not a hearing to determine whether or not certain organizations should be exempted from certain taxes. Rather it is an opportunity for this Committee to determine whether the UBIT statutes and section 501(c) of the IRC are functioning as the Congress intended.

Background

Congress has always sought to shield from taxation charitable, educational, and other types of non-profit organizations. The Revenue Act of 1894 imposed a 2% corporate income tax on "corporations, companies, or associations doing business for profit in the United States." The act specifically exempted from taxation charitable, educational and other entities which were not conducted as a business for gain.

With enactment of the first federal income tax in 1913, Congress once again provided exemptions for certain non-profit organizations. In fact, the list of organizations which would be exempted was expanded, and the law specified that the corporate income tax would not apply to chambers of commerce or boards of trade which were not organized for profit.

The rationale for allowing an exemption for a commercial organization not organized for profit was that while the organization's purpose is commercial advancement, the benefits did not promote an advantage to one individual, but to the community as a whole.

The Revenue Act of 1938 expanded the earlier rationale:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

The points made in this paragraph from the House Ways and Means Committee Report accompanying the Revenue Act of 1938 indicate a strong congressional desire to exempt from taxation organizations which promoted benefits for the public welfare. With the advent of the modern Internal Revenue Code, Congress determined to provide these benefits to organizations that promoted the welfare of businesses and individuals.

The UBIT sections of the IRC were first added in 1950 and were substantially expanded in 1969. The basic intent in implementing the UBIT sections was to prevent unfair competition from occurring between for-profit and non-profit businesses. Clearly the advantages of being designated as a tax-exempt organization were so great, it was necessary to ensure that organizations would not unscrupulously take advantage of their tax-exempt status.

Regulations section 1.513-1(b) of the IRC states:

> The primary objective of the adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business income activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.

The regulations do not attempt to skirt the issue of defining a trade or business; in fact the regulations state specifically that for the purposes of section 513 of the IRC, the term " trade or business" carries the same meaning it has in section 162 of the IRC, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. What has caused the definitional difficulties is the additional requirement that the income must derive from an activity which is not substantially related to the purposes for which the exemption is granted.

Obtaining a federal tax exemption is basic to the survival of the nonprofit entity, and yet it is the least important benefit provided, at least in dollar terms. Once an organization is provided federal tax-exempt status, it then can qualify for exemptions under state and local law. These exemptions are not just from income tax, but also from taxes such as sales and property tax. In addition, exempt charitable and educational organizations are entitled to a reduced rate from the postal service on mailings.

Overview of the Non-Profit Sector

The definition of what type of activity is considered related or unrelated is the basis for much of the disagreement between the small business community and the non-profit community. However, resolution of the problem requires an understanding of the issue beyond viewing the issue as a debate on relatedness. It requires the members of the Committee to understand what the non-profit community has become.

At the present time, there are more than a million nonprofit organizations in the U.S. The modern non-profit charitable organization is often a large, multi-million-dollar organization that is run as a business, using management techniques developed for large corporate organizations. Today's non-profit organization can consist of a multi-tiered organization with a parent and several, sometimes dozens, of subsidiaries.

The National Geographic Organization was the subject of a recent article in the Washington Post. The article detailed how the National Geographic has become, among other things, a major business conglomerate with reported revenues of $326 million in 1984. Remarkably it gave out a little more than $3 million in research grants in 1983.

The recent difficulties of the PTL organization public knowledge. As their financial difficulties became evident, management sought out and hired the individual formerly responsible for managing the amusement facilities from Six Flags Over America, a major for-profit amusement facility.

While the original intent of the organizations, as stated in their charters and their applications for tax exemptions, remains basically intact, today's non-profits are raising funds in ways unimagined just twenty short years ago.

For most charitable organizations, the basic fundraising methods of the past still hold true. They typically hold annual fundraising drives and annual sales events. However, more and more organizations are raising funds through business-related activities.

The best indicator of the changes in fundraising was detailed in a recently released report prepared by the General Accounting Office. The study, entitled Competition Between Taxable Business and Tax-Exempt Organizations, reveals several startling facts about non-profit organizations. In particular, section 501(c)(3) organizations were supporting themselves at an increasing level with revenues raised by other means than by dues and contributions. In 1975, 39% of the funds raised by 501(c)(3) tax-exempt organizations were from business receipts. In 1982, 81% of the revenues from this same group came from other sources. For 501(c)(4) groups, 51% of the revenues were from program services.

Examples abound of the diverse ways in which non-profit organizations are going about raising funds. The February, 1987 issue of Virginia Business detailed how the hospital industry in Virginia has prospered in recent years. The article mentions that the non-profit Roanoke Memorial Hospital has established for-profit affiliates to operate two health clubs, an interior design firm, a pharmacy, and several other businesses.

In many communities, the local YMCA is going through a metamorphosis. Instead of providing facilities and programs for use by any member and special subsidies for those who could not afford membership, the new YMCA is becoming more like the health clubs seen in television commercials -- and they are not open to all YMCA members. Use of these first class facilities requires a separate membership which costs more. The YMCA maintains that the fees are funnelled into programs which help their charitable functions succeed, but the amount of funds dedicated to charitable programs is disturbing.

The August, 1986 issue of Oregon Business ran an article entitled "What's Fair is Fair." In Multnomah, Oregon, the county tax assessor denied a property tax exemption to the YMCA under construction. The denial was based on the county assessor's determination that the YMCA was spending only 11% of its Multnomah County operating revenues on charitable purposes, and this level did not qualify the YMCA for the property tax exemption.

In the February, 1985 edition of Association Management, there was an article entitled "When Associations Become Entrepreneurs." The article describes a non-profit organization which has developed a for-profit subsidiary to operate as a wholesaler for college bookstore members. It provides anything the college bookstores may want, including computers, software, student magazines, and cosmetics. This has turned into a $12 million business which has slowly resulted in many college bookstores competing with a growing list of off-campus facilities.

Other articles in various newspapers and magazines discuss the concerns by some that the move by non-profit organizations into the for-profit sector is resulting in non-profit hospitals losing sight of their responsibility to provide quality care for the indigent, run teaching programs, and otherwise take care of the community's health needs. In addition, there may be conflicts of interest between hospitals and doctors when the doctors have a financial interest in the success of the hospital. Often the hospital will exert formidable pressure on staff doctors and doctors affiliated with the hospital to refer patients only to subsidiaries of the hospital.

These examples are but a few of the hundreds which NFIB members have provided to us and which have been catalogued in their respective categories. Briefly, some of the other examples are:

o Many non-profit health-related organizations are branching out into related and unrelated business areas. For instance, many hospitals that operate on-site laundries are soliciting business from the local community; pharmacies are permitted to sell to anyone walking through the door; non-profit hospitals exert pressure on employees to ensure that sales and rentals of durable medical equipment to patients leaving the hospital are directed towards hospital owned and operated subsidiaries; health clubs are being opened; commercial real estate ventures are being established; community outreach centers operating as mini-clinics are competing with doctors and others involved in promoting local medical centers.

o While use of hearing aids has doubled nationally, dealers in St. Louis have not seen any increase in sales because 13 non-profit hospitals have begun dispensing hearing aids during this period, and their ability to restrict referrals limits sales for many small business owners who have been in the business for years.

o Travel agents are constantly forced to compete with university - subsidized travel packages and plans offered by tax-exempt organizations such as National Geographic and the American Association of Retired Persons (AARP). Incidentally, all of the mailings which include the solicitations are made using the subsidized postal rate of the organizations.

o At the Metropolitan Museum of Art in New York, visitors can buy calendars, desk diaries, stationary, post cards, and other gifts, which include reproductions of some of the museum's more popular works.

o In one community in a Midwestern state, the local church holds an annual event in which oriental rugs are brought in for a special sale. The rugs, which purportedly are being offered at reduced prices, are snatched up by patrons of the church who believe they are getting a bargain. No sales tax is collected, and neither the business nor the church pay income tax on the sales. The sales for this once-a-year event totalled nearly $350,000, which equals the annual gross sales of the average NFIB member. The mailings made to announce the event were made using the subsidy provided by the postal rates.

o Private colleges and state universities offer, through their alumni clubs, the opportunity for using a credit card. 1% of all sales made on these cards is funnelled back to the alumni fund. In addition the alumni fund receives a $25 finders fee for each member signed up. Add to these facts that the solicitation is made at the reduced rate subsidy provided by the Postal Service to the university.

o A State-supported university allows its scientific departments to use their testing equipment to sell services as a testing lab to the private sector. They use university equipment paid for through grants and state and federal funds, and all the labor is performed by graduate students.

o In several states local Humane Society facilities have expanded beyond providing spaying and neutering facilities to poor families with pets. Once established in the community, they reach out to the general community and, regardless of income, offer for-fee services including grooming and elective medical procedures, in direct competition with veterinarians who must pay taxes.

o A business which provides film and video tape services for local businesses for use in filming television commercials is competing with a television studio run by a local church for the same commercial business.

SO WHAT?

NFIB members across the country have provided us with hundreds of examples of situations where they are being out bid for business by some type of non-profit or tax-subsidized organization. Mr. Chairman, you and the other members of this committee must by now be asking one question: SO WHAT?

What is the problem with these activities? Are they not legal, are they avoiding taxes, or are the small businesses simply being outclassed by better business operators?

The UBIT statute, according to the regulations and committee reports, was designed to ensure that unfair competition did not occur. Is the statute too open ended, providing too great a loophole for the non-profit sector so that such protection is not occurring?

Before these questions can be answered, the range of benefits which accrue to nonprofit organizations should be delineated.

UBIT Statute -- Price Advantage and Market Entry

The UBIT statute and regulations allow the non-profits to exploit the assets and activities of the non-profit and with imaginative planning, very little tax liability will result. This fact is best illustrated by the GAO study on non-profits which revealed that while the non-profit sector accounted for over $300 billion in economic activity, less than $100 million in tax revenues were paid. This gives this industry a federal tax rate of .03%.

The tax exemption leads to other advantages. It provides the tax-exempt organization with an advantage in pricing, allowing it to cut prices to enter into a market. A non-profit organization can enter a market and stay there even at the risk of no profits or moderate losses because the usual economic rules do not apply. These situations can be very disruptive to local economies, especially in small towns, because the normal competitive pressures will not apply.

Borrowed Funds

The revenues from entrepreneurial activities are in part returned to the non-profit parent, but in many cases the funds are reinvested in new business ventures. The ability to generate a nearly endless stream of tax-free capital, or to use the non-profit parents name and equity to borrow funds, or indeed for the parent to simply lend the funds at preferred rates, afford great advantages over small business competitors. One of the greatest problems for small firms over the last ten years has been the ability to raise capital, especially because of the risky nature of investing in any small business.

The non-profit organization is prohibited from raising funds by issuing stock or by attracting outside investors. However, even here many non-profits have managed to use imaginative techniques, and many are involved in the purchase of commercial and residential real estate which is portioned off and sold in limited partnership shares to outside investors. One such situation involves a hospital which has built a professional office building adjacent to the hospital and is selling interests to doctors and other medical professionals.

Asset Prices

A tax exemption provides a cushion for profits and allows a non-profit, when bidding on land or other facilities, to outbid the for-profit business.

Postal Rate Subsidies

Certain organizations can take advantage of reduced postal rates on mailings to its members, and the reduced rates can be taken advantage of to solicit funds, to attract new members, and to promote activities of the organization or benefits available to the members. The subsidy for non-profits is in second and third class mailings, and it is generally available to 501(c)(3), (c)(5) organizations, and organizations classified as religious, educational, scientific, philanthropic, agricultural, labor, veterans, or fraternal.

In many cases the postal subsidies are used to solicit a members purchase of insurance, travel bargains, credit cards, and a whole range of membership benefits.

State and Local Property Tax Exemptions

An organization which is deemed to be charitable and therefore tax-exempt under section 501(c)(3) is eligible to receive exemptions from state and local property taxes. The rules may vary in each state, but essentially the organization must first obtain the federal exemption as a charitable group. Once received, this opens up all of the other necessary doors for tax exemption.

State Sales Tax Exemptions

Many states exempt nonprofits from payment of sales tax. If they are performing services on a regular basis, charitable organizations can often qualify under state law for an exemption from collecting sales taxes. If the charitable or educational organization promotes an annual event, it can usually obtain an exemption from collecting sales tax at these events as well. The rules vary from state to state.

Halo Effect

Possibly the least tangible benefit that a tax-exempt non-profit can point to, but a benefit that may be its most important stock in trade, is what can be called the "halo effect," i.e. the belief and trust of the public that a non-profit charitable organization is operating on behalf of the public welfare and that its efforts are not tainted by the need to make a profit.

This aspect is possibly the most difficult to deal with because it deals with the public's perception of an organization. The halo effect means that these organizations have, either by their deeds or people's perceptions, incurred a substantial amount of goodwill within the general public -- including many local community leaders and many owners of small businesses.

Trading on goodwill is certainly not illegal, but when a non-profit organization trades on its reputation in the area of health care to begin selling memberships in health clubs, one has to begin to wonder if a line has not been crossed.

Recently an article in the Harvard Business Review created a firestorm of controversy. The article was entitled "Who Profits from Non-profits?" and was written by Professors Regina E. Herzlinger and William S. Krasker. The article concludes, among other points: "non-profit hospital chains receive more social subsidies than for-profits. They do not achieve better social results." Just possibly in the hospital industry, the halos are being worn by the for-profit hospitals, too. Certainly the findings of these two researchers would seem to indicate that there may be some doubt in the minds of some individuals.

Labor Market Advantages

Finally, many non-profits are able to attract individuals interested in working for low wages or even as volunteers, thus dramatically lowering labor costs and providing a substantial cost advantage between the nonprofit and the typically labor-intensive small business competitor, who must pay competitive wages and fringe benefits.

Common Threads of the Different Examples of Subsidized Competition Provided by NFIB Members

To help the members of the Committee arrive at their own conclusions on whether these situations may be nothing more than anecdotal or are indicative of a failure in tax policy, it is useful to analyze the common threads in all of the examples and illustrations.

Failure of UBIT Statute

In most of the letters received on the subject of non-profit competition, one point is evident: the failure of the tax statute to provide clear guidance in defining related and unrelated activities for purposes of determining when income should be taxed or not taxed is intolerable. The fact that the courts have so broadly interpreted the concept of the relatedness test is also frustrating and leads many small business advocates to believe that the current framework cannot be fixed to provide the necessary guidance.

It is unclear to us, as I am sure it must be unclear to you, what limits there are for a non-profit organization in promoting an activity which in any manner furthers the organization's tax-exempt purpose. This lack of clarity translates into granting non-profit organizations virtually limitless access to our markets and economy, without the discipline the free market rules of our economy imposes on the rest of us. Perhaps the following hypothetical situation will help clarify the point.

Students Against Drunk Driving is an organization established to educate students and parents about the dangers of driving under the influence of alcohol, and to educate the electorate to insist on stricter enforcement of drunk driving statutes and increased penalties for offenders.

Several years down the road, the organization decides to establish educational programs to tour the schools, free of charge. Then as the need for funds increases to maintain the services it is providing and as contributions level out, management decides to raise funds in a new way. They determine that they can provide driver training classes and driving schools to certify driver education programs to the states. What chance are private driving schools going to have to compete against them? Under the UBIT statute, this activity would probably not be considered unrelated to SADD's original purpose. Therefore the small firms in the driver training business are competing against a non-taxed competitor.

Several years later, with the success of this first program underway, SADD decides to become involved in sales of alcohol detectors for drivers, to measure their level of intoxication. Several years later SADD gets involved in safety designs of cars to protect innocent victims from being hurt by a drunk driver.

This is a hypothetical situation, but based on what has happened with other nonprofits, it is totally plausible. The question to be asked is, is it desirable as a matter of fiscal policy as well as social policy? The small business owners who have been put out of business by the organization would ask Congress, and Congress has to ask itself the same question: when did this organization stop being a non-profit organization and become a business?

The common perception of a non-profit charitable organization is one which raises funds from the public and reinvests those funds in community facilities designed to help those in need. Is there any requirement of how much must be reinvested in the community? The short answer is no. While there are ethical and theoretical guidelines on the benefits which may accrue to the management of a non-profit and its employees, no minimum exists of how many cents on a dollar must be used for the organization's primary purposes.

In fact many organizations would be embarrassed to reveal what percentage of total revenues is returned to the community the non-profit is supposedly serving. That is because the profits of the subsidiaries are in many cases being used to expand the entrepreneurial aspect of the non-profits. Hospitals and universities are becoming conglomerates and holding companies for vast numbers of subsidiaries whose profits are partially returned to the parent, but in large measure are used to capitalize new ventures.

Last January the Small Business Administration's Office of Advocay sponsored a conference on the issue of non-profits. Representatives of both sides of the issue were represented at these sessions. At the discussions on the UBIT, the discussion revolved around the need for new guidance, or a bright line, to be used to determine relatedness or unrelatedness, as well as when an organization is no longer a non-profit but is a business. No conclusion was reached, but the discussions clearly revealed the frustration with the current statutory framework existing in the tax code.

Captive Referrals

A common concern expressed in many of the letters dealt with the issue of captive referrals. This situation is most common in university and hospital situations. Clearly, the university or hospital has an interest in ensuring that when a related subsidiary can provide a service or piece of equipment, the physician refers them to the hospital's subsidiary.

There is a concern that this will lead not just to the demise of many small businesses offering similar services, but also that the potential conflict of interest will cloud the perspective of the physician.

Financing of Subsidiaries

Many of the related businesses or for-profit subsidiaries are capitalized from funds of the non-profit parent. The funds used to capitalize were donated by an individual, who in turn deducted such amount on his or her tax return, and the money was non-taxable income to the non-profit. Is it fair to allow tax-free funds to be used in financing many of these for-profit subsidiaries? Of additional concern is whether the non-profit's eligibility for bank loans are enhanced by the assets of the non-profits.

Cost Allocation Rules

The UBIT statutes typically allow the for-profit to exploit some of the costs of the non-profit parent, resulting in the sharing of the costs of the administrative facilities. These allocations allow expenses, which ordinarily are incurred by the non-profit parent but which would not result in any tax benefit, to be allocated to the for-profit subsidiary where they are deductible under the UBIT rules. The allocation rules need to be strengthened and clarified to prevent this unncecessary gamesmanship played with the IRS audit process.

Postal Subsidies

Reduced postal subsidies allows the non-profits to mail advertising and literature informing the membership of services available. The reduced rate subsidies are also used to inform the membership of bargain airfares, insurance discounts, and other benefits arranged for the members.

Providing Services or Products to the General Public

In many cases the for-profit subsidiary and the non-profit parent are marketing services to the general public, not just to the indigent. Why should they be taxed any differently?

IRS Enforcement

The issue of IRS enforcement was not mentioned earlier because directing the IRS to devote more resources to audits will not solve the problem. Certainly, better enforcement is necessary. The audit rate of non-profits is embarrassing, and the results of the audits leave many questions unanswered.

It is our strong belief that the basic UBIT statute and the regulations need to be revised. The UBIT statute is too vague and leaves too many opportunities for interpretation to be considered effective in solving the problems of subsidized competition. The UBIT statute was intended to provide an enforcement mechanism, but as we have discussed, the rules for determining related and unrelated activities are unclear, the allocation rules provide more benefits than enforcement, and the enforcement is inadequate.

Suggestions for Action

The issue of unfair competition with nonprofits is both disturbing and complex. We have attempted to provide the Committee with examples of the increasing level of commercial activity occurring within the nonprofit sector, and we have outlined the various tax and non-tax benefits afforded the nonprofits -- benefits which are not given to their small business rivals in the commercial marketplace. Yet many of these same small business onwers are active supporters of the primary activities of the nonprofit organizations.

Nevertheless, the phenomenal growth within the nonprofit sector and the rapid escalation of commercial ventures to raise revenues compel us to suggest to the Committee several options to begin promoting increased accountability by the nonprofits for their activities.

Central to increased accountability is a carefully-crafted revision of the UBIT statute and IRS Sections 501 and 511-514. While local jurisdictions have made some headway in tackling the issue, leaving resolution of the problems entirely to state and local action would be a mistake, resulting in a patchwork quilt of laws and rules which would do little to clarify an already-confusing situation. As nothing can begin until the federal tax exemption is granted revision of the federal statutes is a necessary solution.

In revising the UBIT, the first priority should be to make as clear a distinction as possible between related and unrelated activities. Guidelines or minimum standards must be provided that an organization must meet to claim status as a tax-exempt organization. Some limitation must be established to ensure the nonprofit treats non-contributed income as unrelated income. Some consideration must be given to limiting the amount of income a nonprofit can generate from business activities and declare as related. Or, fix a statutory limit -- perhaps a percent of revenues -- a nonprofit can generate from business activities without losing its tax-exempt status.

Another approach might be to revise the UBIT and Section 501 to require arms' length transactions between a non-profit and its for-profit subsidiaries. A requirement might also be established for a nonprofit to file an application with the IRS to receive a predetermination on whether a proposed activity is related or unrelated before such activity is begun.

Another suggestion is to consolidate the categories of tax-exempt organizations under section 501. Consolidation and clarification of the types of activities that qualify for tax-exempt status is essential.

Revision of the statute should be accompanied by increased IRS audit coverage. Audits should be conducted with greater frequency and in much more detail than has occurred in the past. In addition, IRS should develop new forms for reporting information. The 990 forms do not require enough information to allow adequate IRS review of a nonprofit's activities. However, increased enforcement alone is not the answer. It will only be effective if it is a part of a change to the basic UBIT statutory framework.

Conclusion

Mr. Chairman, once again I congratulate you for holding these hearings. The problem is complex, but it is one which I am convinced requires a solution. The non-profit sector and the small business sector are in many senses intertwined in their common goals for a strong economy and a nation which cares for its people. Many non-profits could not survive without the active support and funds of the millions of local small business owners and their employees.

Our economy is strong enough and big enough to support all of us and it is not with the interest of eliminating the non-profit sector that I appear before you today. Fair competition is the basis for our entire economy just as much as caring for those who need help is the basis for our social fabric.

What is most alarming to the small business community is that the amazing increase in business activities by non-profits results in direct pressure on the nation's tax base and results in heavier tax burdens for those who pay the taxes.

I am prepared to answer any questions you may have.

0288T

Suite 700
600 Maryland Ave. S.W.
Washington, DC 20024

(202) 554-9000

National Federation of
Independent Business

NFIB

Congressman J.J. Pickle
Chairman, Oversight Subcommittee
House Ways and Means Committee
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Pickle:

The hearings on the Unrelated Business Income Tax and Non-Profit Competition by your oversight subcommittee have proven to be the eye opener many of us in the small business community thought that it would be. However, as you have seen one of the difficult aspects of this issue is that hard facts and proof is difficult to come by.

Beginning last January NFIB undertook a fact finding campaign among its membership to determine where the issues in the non-profit competition area were and what type of competition problems existed. We were anxious to know, as are you, the type of problems that the membership was encountering in this area and who they were expriencing the unfair competition from.

As a result of our request for information we received approximately 350 letters and many phone calls. The 350 letters we received can be categorized into the following specific issue areas:

Hospitals	35 cases
Universities	40 cases
YMCA	15 cases
Veterinarian	24 cases
Churches	13 cases
Fraternal Organizations	16 cases
State and Local Governments	23 cases
Utility Competition	19 cases

Additional letters were received expressing general support for investigating this issue, while others raised issues of competition which do not relate to the issue of unrelated business income.

Enclosed is a partial sampling of the examples of competition with non-profits which are in our case log. We are continuing to process additional cases into this log and we will forward the cases to you shortly.

The NFIB members who provided these examples are obviously concerned over what they view as an increasing emphasis by the non-profit sector to compete with them in the open markets. In virtually every situation they cite an area where a tax-exempt organization is competing with them.

They are not however, in any position to know how the tax-exempt organization treats the income from the activity. They do not know whether the activity is as a related or unrelated, and, if it is unrelated, whether the non-profit parent is exploiting expenses which otherwise would have been paid by the non-profit.

NFIB is anxious to provide you with all the information we gather on this question, and we are ready to engage in discussions with your staff on the possible options for changes in the legislation.

Sincerely,

John

John J. Motley III
Director
Federal Governmental Relations

4648D

NON-PROFIT CASE - NO. 1

DATE: March 11, 1987

MEMBER: Kenneth I. Booher, President

ADDRESS: Hoosier Alarm and Security
2504 North Arlington Avenue
Indianapolis, IN 46218

PHONE: (317) 545-2488

ACTIVITY: Non-Profit Hospital Community Hospital of Indianapolis has established a for profit subsidiary to install burglar alarm systems in private residences. The service offerred include: Fire and security alarm system installation and monitoring, fire and safety education programs, security officer service, process and environmental control monitoring.

ISSUES:

1) Activity Is Related to Exempt Purpose
2) Unrelated Business Income
3) Overhead Costs, Captive Referals

STAFF ANALYSIS:

This letter relates several issues and illustrates one of the more interesting examples of why the definition of what is a related activity is so important in this debate. It illustrates that the issue can not be solved by a simple adjustment of the UBI statute, but that the basic exemption statute needs to be addressed as the definition of what is related has been so broadly interpreted.

NON-PROFIT CASE - NO. 2

DATE: March 11, 1987

MEMBER: Charles D. O'Connor, President

ADDRESS: North American Medical Supplies Corporation
130 Metro Park
Rochester, NY 14623

PHONE: (716) 424-5030

ACTIVITY: North American Health Care, a local Non-Profit Hospital unfairly competes in sales of durable medical equipment. These include orthpedic equipment and home respiratory service. Captive referrals are wiping out independents in his area. In addition, they are buying out formerly independent health service companies furthur solidifying their hold on the decreasingly competitive market.

ISSUES:

1) Related Activities Exempt Status
2) Unrelated Business Income
3) Captive Referrals

STAFF ANALYSIS:

The activities of non-profit hospitals in establishing subsidiaries to sell patients equipment is widespread. The many advantages include initial financing, captive referrals by physicians on staff, tax benefits.

NON-PROFIT CASE - NO. 3

DATE: March 11, 1987

MEMBER: Morris A. Link, D.V.M.

ADDRESS: Spring Harbor Veterinary Associates
5129 University Avenue
Madison, WI 53705

PHONE: (608) 238-3461

ACTIVITY: Local Humane Society is competing with local Vetrinarians. They can offer similar services for far less due to tax status. They are serving those who could not afford to pay for pet care as well as those who can.

ISSUES:

1) Charitable group marketing to non-indigent
2) Unrelated Business Income
3) Halo Effect

STAFF ANALYSIS:

Vetrinarians in many states have written to make a similar complaint about the humane society. Apparently they benefit from a court case which grants them tax free status on all earnings. State of Michigan is waging strongest battle in this area with legislation pending.

NON-PROFIT CASE - NO. 4

DATE: March 11, 1987

MEMBER: Alan J. Vogenberg, P.D., FASCP

ADDRESS: President Windsor Pharmacy, Inc.
1506 Haines Road
Levetown, PA 19056

PHONE: (215) 945-1125

ACTIVITY: Local health care agency and union is providing retail pharmaceutical services to public at prices he can not compete with.

ISSUES:

1) How is retail pharmacy related to exempt purpose
2) Unrelated Business Income
3) Low cost financing, mailing costs, free advertising

STAFF ANALYSIS:

Unions and health care facilities are commonly using retail pharmaceutical mail order houses and constructing on site facilities for members. Often non-members are not discouraged from usage. Whether UBI statute is clear enough in this situation is a major point.

NON-PROFIT CASE - NO. 5

DATE: March 11, 1987

MEMBER: Thomas F. Frist, Jr., M.D.

ADDRESS: The Health Care Company
1 Park Plaza, P.O. Box 1550
Nashville, TN 37202-0550

PHONE: (615) 327-9551

ACTIVITY: Mr. Frist writes to complain over competition with non-profit hospitals in the Memphis Tennessee area. He cites as evidence of unfair competition an article from the Memphis Tennessee Commercial Appeal,dated Sept. 11, 1985. The article lists the profitability of several non-profit hospitals locally and states that three of the major hospitals had profits greater than the top of three Fortune 500.

ISSUES:

1) Non-profit hospitals- defining related activities
2) Unrelated business income
3) Captive referrals, financing

STAFF ANALYSIS:

This member is raising the same questions on the non-profit hospitals that other letters raise. Basically, the NFIB members feels the advantages of the non-profit hospitals are too great allowing them to become more profitable than the for profits.

The letter details that St. Francis Memorial Hospital in Memphis and the Baptist Memorial Hospital utilized a reserve account to arrive at a net operating loss. In 1984, Baptist Hospital of Memphis claimed its net income was $48.8 million. It then deducted $50.5 million in net reserve exepnses to reflect a loss. Loan~ were recorded to the parent and subsidiaries.

NON-PROFIT CASE - NO. 6

DATE: March 11, 1987

MEMBER: Robert R. Mercer

ADDRESS: Visual Communications, Inc.
1634 South Boulder
Tulsa, OK 74119

PHONE: (918) 587-4024

ACTIVITY: University of Oklahoma is allowed to bid on contracts for audio visual aids and are able to under bid by sufficient amounts to win many contract awards.

ISSUES:

1) How is activity related to education
2) Unrelated Business Income
3) Financing, and capitalization of business

STAFF ANALYSIS:

This is an example of a university using its tax free status and financial assets to establish a business in competition with local business owners. They are utilizing the taxpayer provided facilities to compete with taxpayers.

NON-PROFIT CASE - NO. 7

DATE: March 11, 1987

MEMBER: James F. Ritchey, President

ADDRESS: Workable Systems, Inc.
917 Macon Place
Raleigh, NC 27609

PHONE: (919) 787-2834

ACTIVITY: Local university, the North Carolina Department of Industrial Engineering publishes a listing of course offerrings and seminars in direct competition with local consultants and other private businesses with expertise in the same areas.

ISSUES:

1) Relatedness test
2) Unrelated business Income
3) Financing, mailing costs

STAFF ANALYSIS:

The university is taking advantage of its non-profit status by financing such outside activities through the university, it must also be using its reduced rate mailing privledges on solicitations, it does not consider these activites in determining unrelated business income. It uses its halo effect to solicit business away from for profit competitors.

NON-PROFIT CASE - NO. 8

DATE: March 11, 1987

MEMBER: Gerald M. Liss, President

ADDRESS: Pisanello's Pizza
203 North Main Street
Bolling Green, OH 43402

PHONE: (419) 352-5166

ACTIVITY: Bowling Green State University has allowed pizza parlors on campus to solicit business from off campus through direct advertising to the public.

ISSUES:

1) Relatedness Test
2) Unrelated Business Income
3) Financing, advertising

STAFF ANALYSIS:

Original capitalization was done through university provided funds and presents no problem as long as activities remained on campus. Soliciting off campus business with free financing and low cost advertising gives the university pizza parlor a major advantage in price and referrals.

NON-PROFIT CASE - NO. 9

DATE:	March 11, 1987
MEMBER:	Calvin L. Koenig
ADDRESS:	Koenig Camera Shop, Inc. 162 Shoppers Lane Covina, CA 91723
PHONE:	(322) 322-1510

ACTIVITY: Competition from local community college selling film and other photographic supplies at a discount to their students.

ISSUES:

1) Relatedness
2) Unrelated Business Income
3) Financing

STAFF ANALYSIS:

The issues of allowing a university to sell in competition with commercial for profits off campus is questioned. The business is competing against a non-profit with all of the obvious advantages.

NON-PROFIT CASE - NO. 10

DATE: March 11, 1987

MEMBER: William G. Palermo, Jr.

ADDRESS: William G. Palermo, Inc.
441 Northwood Avenue
Linden, NJ 07036

PHONE: (201) 486-2626

ACTIVITY: Mr. Palermo is an insurance agent and he writes concerning the unfair advantage an organization such as the American Association of Retired People have on marketing their insurance programs. He is not objecting to the competitions but wants to ensure that on commercial profits, that they pay taxes. He has written to Senators Lautenberg, Bradley and Cong. Rinaldo.

ISSUES:

1)Relation of activity to exempt purpose.
2)Advantages of AARP solicitation and use of name.
3) Advantage of reduced postal rates.

STAFF ANALYSIS:

This letter relates the advantage which a well known non-profit can have in selling products and services which should be aside from its exempt purpose. The member does not comment on whether these activities are treated as related or unrelated.

NON-PROFIT CASE - NO. 11

DATE: March 11, 1987

MEMBER: K. J. Law, P.E., President

ADDRESS: K. J. Law
23660 Research Drive
Farmington Hills, MI 48024-1089

PHONE: (313) 478-3150

ACTIVITY: Mr. Law writes to object to competition he is facing with Penn State Univeristy transportation suit and the University of Michigan's Transportation Research Institute and similar others. He feels that these tax-exempt groups should not be competing in the commercial business area. Mr. Law is in the engineering consulting and testing business.

ISSUES:

1) HOw is Activity Related to Exempt Purpose and Education
2) Usage of tax exempt facilities to run a business
3)

STAFF ANALYSIS: This letter is an example of the problem of Universities competing with testing labs and consulting firms. They utilize university facilities paid for with tax exempt or tax subsidized funds. Then utilize paid professors and graduate students to gain experience.

NON-PROFIT CASE - NO. 12

DATE: March 11, 1987

MEMBER: Paul Woodard

ADDRESS: Woodard Hearing Aid and Speech Center
4217 Univeristy Avenue
Des Moines, IA 50311

PHONE: ( )

PROBLEM: Mr. Woodard has a problem with the Des Moines Speech and Hearing Center which is non-profit and has its offices at United Way plus receives a $200,000 subsidy from the United Way. They have now started selling hearing aids and is in direct competition with him. Private dealers in Des Moines are serving more Medicade people than the agency which Woodard says is selling to the rich. He has not contacted any of his legislators.

ACTION TAKEN:

NON-PROFIT CASE - NO. 13

DATE: March 11, 1987

MEMBER: Harry B. Eddy

ADDRESS: New System Laundry, Inc.
P.O. Box 1096, 82 Parris Street
Portland, ME 04104

PHONE: ( )

PROBLEM: Mr. Eddy's letter complains about competition from the Portland YMCA Boys Club and Portland School Department. He claims to have lost out on laundry contracts to these three organizations in recent years. These organizations currently have in-house laundry processing and they are apparently soliciting business from the business community. He also feels that it is absurd for non-pfofit hospitals to build facilities when there is already capacity to handle their situation in the business community. He has written Senators Cohen and Mitchell, and Cong. Brennan.

ACTION TAKEN:

NON-PROFIT CASE - NO. 14

DATE: March 11, 1987

MEMBER: Walter Killian

ADDRESS: Availability of New Hampshire
1000 Elm Street
Manchester, NH 03101

PHONE: ( )

PROBLEM: Mr. Killian runs an independent employment agency. He is competing with Matchworks, which is a part of the YMCA. Apparently they are able to offer lower employment rates that Mr. Killian would find impossible to match.

ACTION TAKEN:

NON-PROFIT CASE - NO. 15

DATE: March 11, 1987

MEMBER: G. W. Detterman, Jr.

ADDRESS: Bay Side Pharmacy
4801-A Shore Drive
Virginia Beach, Va. 23455

PHONE: ( ) 464-1463

PROBLEM: Mr. Detterman encloses an article discussing the problems he is facing with his local hospitals. As an example, he sites an article in the newspaper that illustrates the fact that Chesapeake Hospital in the Virginia Beach area is in the catering business. He does not understand how this kind of activity can be allowed by a non-profit hospital.

NON-PROFIT CASE - NO. 16

DATE: March 16, 1987

MEMBER: David L. Wexler, President

ADDRESS: Household Agencies and Nurses Registries Association
71-09 Austin Street
Forest Hills, NY 11375

PHONE: (718) B08-2700

PROBLEM: Mr. Wexler writes over a problem he has with non-profit hospitals who charge fees for obtaining private duty nurses. The hospitals have access to the patient directly and they do not make the patients aware of outside nurses regestries, so he is prevented from obtaining any of the hospital business. Private registries are licensed, bonded and supervised by state law. All fees are charged according to a law written in 1905. He claims hospital registries are not bonded, licensed, investigated or controlled in any way.

ACTION TAKEN:

NON-PROFIT CASE - NO. 17

DATE: March 16, 1987

MEMBER: Joe Stivers

ADDRESS: Joe Stivers and Associates Real Estate
1220 University Avenue
Huntsville, TX 77340

PHONE: (409) 295-0031

PROBLEM: Mr. Stivers is expressing his concern over examples of tax-supported entities and charitable organizations, getting involved in businesses traditionally reserved for free enterprise. He sites the example of the Sam Houston State University Board of Regents in Huntsville, Texas, that is considering the purchase of two apartment complexes. An additional example is the Texas Department of Corrections has offered to lease prime interstate frontage to a firm for the construction of a truck stop. He claims that this will result in unfair competition for the truck stop across the street who has to figure all the necessary ad valorem taxes, his pricing plus the cost of doing business. In addition, he claims the Walker County Sheriff Department is going into the private security business competing with a private security firm. He finds this trend very disturbing. He has written to Cong. Charles Wilson.

ACTION TAKEN:

NON-PROFIT CASE - NO. 18

DATE: March 16, 1987

MEMBER: James Kennerly, D.V.M.

ADDRESS: Mast Boulevard Pet Clinic
10251 Mast Boulevard, Suite D
Santee, CA 92071

PHONE: ( ) 448-6490

PROBLEM: Mr. Kennerly is a veterinarian and is complaining of competition that taxpaying veterinarians are having from non-profit humane societies. He recommends we speak with someone in the Michigan Veterinarian Society on this issue. Apparently, the Michigan Veterinarian Society has been heavily involved in trying to limit the unfair competition from the Humane Society.

ACTION TAKEN:

NON-PROFIT CASE - NO. 19

DATE: March 16, 1987

MEMBER: Dorothy N. Delicato, Treasurer

ADDRESS: Delicato Vineyards
12001 South Highway 99
Manteca, CA 95336-9209

PHONE: (209) 239-1215

PROBLEM: Miss Delicato has written about the fact that certain wineries enjoy special tax benefits placing them at a market advantage. Her family-owned winery "would appreciate it if all commercial businesses would all play by the same rules." She has written to Cong. Shumway.

ACTION TAKEN:

NON-PROFIT CASE - NO. 20

DATE: March 16, 1987

MEMBER: Robert W. Henson

ADDRESS: Henson Ambulance, Inc.
P.O. Box 69
Bourbonnais, IL 60914

PHONE: ( ) 933-9571

PROBLEM: Mr. Henson started his ambulance service in 1973. In the summer of 1973, the Department of Transportation entered the market with grants for governmental agencies that resulted in the establishment of twelve fire departments giving free service supported through taxes. The fire departments also have various fundraising events to to help support the ambulance services. Presently, some of the departments charge a nominal fee far below the actual cost of operation. In addition, to maintain their eligibility to stay in business, they had to be manned 24-hours a day, 365 days a year as opposed to the fire departments that are paid on-call and operate on an call-in basis. They feel that the rules are discriminatory requiring them to undertake the greater burden. Indirectly, they also received competition from the American Red Cross and the YMCA for CPR classes. Their customary charge for a CPR class is $10 per person, the Red Cross charges $7.50 and the YMCA only $2. He feels many of these agencies do not reflect the true cost of their operations and their budgets because their budgets overlap each other and they rely on many outside activities. He has written to Senator Simon and Cong. Madigan.

ACTION TAKEN:

NON-PROFIT CASE - NO. 21

DATE: March 16, 1987

MEMBER: C. H. Whiteside, Ph.D., President

ADDRESS: ANA Lab Corp.
2600 Dudley Road
Kilgore, TX 75662

PHONE: (214) 984-0551

PROBLEM: Professor Whiteside owns a testing lab and he has been in business for 22 years and operated a chemical testing laboratory that offers a variety of services. He is facing competition from government and other non-profit agencies. Apparently, the Texas Department of Health, certifies laboratories for the analysis of public water supplies, and they have decreed that only non-profit laboratories will be certified. An additional example is that soil and forest testing services are being provided by Texas A&M University, Stephen S. Austin State University, and Wharton Junior College. These services are provided below cost subsidized by my tax dollars and competing with my business. He has written to Cong. Hall.

ACTION TAKEN:

NON-PROFIT CASE - NO. 22

DATE: March 16, 1987

MEMBER: Herb Wilson, Vice President

ADDRESS: Wilson Insurance Brokers, Inc.
18130 Midvail Avenue, North
Seattle, WA 98133

PHONE: (206) 546-5101

PROBLEM: He is in the insurance business and is concerned as another case was, with the competition he is receiving from the American Association of Retired Persons in the insurance business.

ACTION TAKEN:

NON-PROFIT CASE - NO. 23

DATE: March 16, 1987

MEMBER: Dudley G. Gray, President

ADDRESS: L. A. Gray Company
Route 1
Hancock, ME 04640

PHONE: ( ) 422-3321

PROBLEM: Mr. Gray has a particular complaint with the Bangor Hydro Utility Company. Apparently, the local public utility is giving away merchandise that retailers and contractors stock and try to sell every day. He feels that he is being charged by the utility, excessive rates so that they can go ahead and purchase water heater insulation kits, energy-saving showerheads, flow-restricing faucet airators from other suppliers and install them free of charge to customers. He has written to his state delegation in Maine, Cong. Olympia Snowe and Senator Cohen.

ACTION TAKEN:

NON-PROFIT CASE - NO. 24

DATE: March 16, 1987

MEMBER: Tom Ferguson

ADDRESS: Respiratory Products, Inc.
P.O. Box 12448
Florence, SC 29504

PHONE: (   )

PROBLEM: Mr. Ferguson sells medical equipment for home patients. There is a community-owned hospital that is opening a for-profit subsidiary to provide durable medical equipment. This is unfair competition because all the patients leaving the hospital are going to be referred to the hospital-owned company.

ACTION TAKEN:

NON-PROFIT CASE - NO. 25

DATE: March 16, 1987

MEMBER: Bert Register

ADDRESS: Register T.V. and Appliance
P.O. Box 38
Rentz, GA 31075

PHONE: (912) 984-4367

PROBLEM: Mr. Register is facing competition from his local rural telephone co-op. Apparently, they have gone into the business of selling satellite dishes and providing sales and service. He feels that the telephone co-op not only gets specialized tax status but is able to raise money at rates far below that he can. In addition, he has invested substantial amounts of funds in training employees for this issue.

ACTION TAKEN:

NON-PROFIT CASE - NO. 26

DATE: March 16, 1987

MEMBER: Ronald O. Crouse

ADDRESS: Bay City's Ambulance and Medical Supplies, Inc.
P.O. Box 575, 3585 Ocean Blvd.
Coos Bay, OR 97420

PHONE: (503) 269-1155

PROBLEM: Mr. Crouse operates an ambulance and medical supply company and has been doing so for 14 years. Currently, his business does sales in excess of $500,000 a year. He has a total payroll of $250,000 that also helps the community. He is concerned that the federal government provides grants and other forms of aid to create services that compete for the private sector. His business has provided for the last three years, air transport for critically injured patients to Eugene, Oregon. They have to compete with Mercy Flights, Inc., a non-profit corporation that does not have to meet state regulations that qualify in medical EMC personnel. Currently, they are now being asked to compete for the county organization receiving grant money from cigarette and alcohol taxes, specifically dedicated to elderly transportation. They have provided wheel-chair van transportation services for 11 years. When they began the service, the price was $10 a person, it is now $15 a person. However, this service that is basically a non-profit service, is offering the same service to $3 per move.

ACTION TAKEN:

NON-PROFIT CASE - NO. 27

DATE: March 16, 1987

MEMBER: Robert Elerick, President

ADDRESS: Western Medical Supply
P.O. Box 6307
Great Falls, MT 59406

PHONE: (406) 727-7611

PROBLEM: Mr. Elerick is in the business of supplying durable medical equipment, including medical oxygen and respiratory equipment. His business is targeted primarily in supplying these facilities to home patients. He has recently found several non-profit hospitals in his area, funding for-profit ventures and competing with him. He sites the numerous advantages that they have, including mass purchasing power, tax exemptions and captive referral sources.

ACTION TAKEN:

NON-PROFIT CASE - NO. 28

DATE: March 16, 1987

MEMBER: Patrick S. McLafferty, President

ADDRESS: Pacific Management Dynamics Corp.
910 Florin Road, Suite 209
Sacramento, CA 95831

PHONE: (916) 427-7676

PROBLEM: Mr. McLafferty's situation is unusual. He owns a management consulting firm that provides data base development to municipal governments. The data base development relates specifically to the qualification of contractors who receive building permits. Apparently, about a year ago, the city and county of San Diego established a non-profit corporation to compete with him.

ACTION TAKEN:

NON-PROFIT CASE - NO. 29

DATE: March 16, 1987

MEMBER: Paul Smith, CEO

ADDRESS: The Aid Company, Inc.
3969 Meadows Drive
Indianapolis, IN 46205

PHONE: (317) 546-1581

PROBLEM: Mr. Smith is in the school transporation business and ambulance business in the state of Indiana. Apparently, legislation has been introduced that would exempt not-for-profit corporations that have meant to the transportation business for meeting certain state requirements. In effect, not-for-profit corporations would be exempt from all Public Service Commission of Indiana safety regulations and insurance requirements and are providing the exact service provided by private enterprise organizations subject to regulation. To make matters worse, some of these not-for-profit providers often receive federal funds to purchase their vehicles and equipment and then they do not pay any taxes on profits.

ACTION TAKEN:

NON-PROFIT CASE - NO. 30

DATE:	March 16, 1987
MEMBER:	Daniel B. Meyer
ADDRESS:	RPH Everman Pharmacy, Inc. 1721 Everman Parkway Everman, TX 76140
PHONE:	( ) 293-0661

PROBLEM: Mr. Meyer is a pharmacist and he is concerned over competition from non-profit hospitals and pharmacies that they are opening in direct competition with him. Due to their church connection status, they can sell prescriptions at a fraction of what we can and cause his prices to seem outrageous. The American Association of Retired People mailorder and local pharmacies are another example of practices on a similar scale. He has written to Senator Gramm of Texas.

ACTION TAKEN:

NON-PROFIT CASE - NO. 31

DATE: March 16, 1987

MEMBER: Tom Inman

ADDRESS: Virginia Home Medical
12436 Warwick Blvd.
Newport News, VA

PHONE: ( ) 596-9600

PROBLEM: Mr. Inman is in various aspects of the medical equipment business. Several years ago, he was operating a successful infant home monitoring program that he had set up with an investment of $50,000. The program was run by his staff respiratory therapist and had become very accepted by local physicians. Subsequently, a local non-profit hospital decided it would be in their best interest to begin their own infant home monitoring program. To raise capital and purchase the monitors, they sponsored a fundraising event and as a result, raised $29,000 tax free, $15,000 of funds were used to $15,000 of the funds were used to purchase the home monitors. The hospital staff physicians have the new hospital program outlined to them as follows: if you need monitors, then you will see to it that the hospital gets the support of your patients with health insurance. As a result of this non-profit program, three-years vested in our business died a very quick and silent death. Mr. Inman has other specific examples where hospitals initiated special barriers towards patients using equipment not rented through a hospital subsidiary. Mr. Inman has written to Senator Trible and Cong. Bateman.

ACTION TAKEN:

Chairman **Pickle**. Well, we thank you, Mr. Motley, for a full statement and for your condensation of it. You made some very important points.

Now we will hear from Peter Swords, executive director of the Nonprofit Coordinating Committee. Mr. Swords.

STATEMENT OF PETER SWORDS, EXECUTIVE DIRECTOR, NONPROFIT COORDINATING COMMITTEE OF NEW YORK, ACCOMPANIED BY LINDA WOLF JONES, MEMBER OF THE BOARD

Mr. **Swords**. Thank you, Mr. Chairman. I have a longer statement which I have submitted with your committee. I would like to, before I begin, note that I am accompanied today by my board member Linda Wolf Jones who is director of public policy at the YMCA of Greater New York.

Chairman **Pickle**. We are glad to have you here.

Mr. **Swords**. My name is Peter Swords. I am the executive director of the Nonprofit Coordinating Committee of New York. We are a membership organization of slightly more than 200 501(c)(3) nonprofits formed to advance and protect the interests of the New York City 501(c)(3) community.

Our members range from storefront human services organizations to the Metropolitan Museum of Art. We regard these hearings with considerable alarm because of their potential to jeopardize the income nonprofits so desperately needed to provide public services.

Proposals for punitive legislation appear to be a response to a well-orchestrated public relations campaign and a few anecdotal complaints. There are no hard facts, however, as the GAO report, "Competition Between Taxable Business and Tax-Exempt Organization" so plainly shows.

Before any action is taken a serious and comprehensive examination should be conducted. America's nonprofit charitable sector is unique in the world. No other nation has as many nonprofits operating to provide as wide a variety of public benefits.

These nonprofits release the energies of millions of volunteers to deal with the broadest range of community problems. To legislate against this sector without having first found out the facts would be tragic.

Related to the last point we are not at all opposed to the promulgation of rules that would require greater disclosure by exempt charities, both to the Government and to the public.

The public relations campaign against nonprofits waged with particular force by the Business Coalition for Fair Competition, claims that nonprofits have an unfair competitive advantage over taxable businesses because of their tax exemption.

Such a contention could only be supported if an examination revealed one of the following: first, that nonprofits engage in predatory price-cutting to acquire a dominant share of the market.

Or second, that their entry into any one market has been so extensive as to significantly affect the level of supply in that market, causing a reduction of prices to below competitive levels.

Common sense suggests that this is not the case, and we believe that this will be confirmed by careful study. Further, we believe that where instances are found of nonprofits underpricing for-profit concerns, it will also be found that the new price level attained is closer to the level that would be reached if that market was perfectly competitive, a result that benefits all consumers.

Consequently, the claim must be that tax-exempt organizations have an unfair advantage over taxable businesses merely because one group is taxed and the other is not.

This claim, however, overlooks the reason for providing tax exemptions in the first place. Even though a nonprofit is tax-exempt, no one, absolutely no one profits individually from its activities.

Reasonable salaries may of course be paid to employees. Any small surplus that might be generated by a nonprofit is applied to supporting the public or community benefit for which the organization earns its exemption.

In stark contrast, the profits generated by for-profit businesses are paid over to the firm's individual owners or shareholders for their private benefit.

We tax the latter and not the former because in the former case any net income realized by nonprofits is used to support the provision of goods and services which help the entire community.

Turning directly to the unrelated business income tax, some object that the distinction between nontaxable-related business and taxable unrelated business is unclear, and difficult to enforce.

We believe that behind these criticisms is a desire to tax the income from related businesses, but this would make little sense. As suggested, it is unlikely that there are real competitive inequities for nonprofits engaging in these activities and sound policy reasons for the longest time have exempted the income of nonprofits from tax. Indeed, it makes eminent sense for nonprofits to undertake related activities. They have personnel trained in the field, facilities, and the experience that makes them especially suited to do this work in an efficient manner.

This results in the provision of products and services that benefits consumers and provides urgently needed income that enables nonprofits to better perform their exempt function.

In a word, the differentiated treatment of related and unrelated activities is sound, and has worked well since it was introduced by Congress in the early 1950's. There may be certain exempt nonprofits whose claim that a segment of their income should be nontaxable because it is related should have been challenged by the Internal Revenue Service, but was not because of the lack of staff resources.

Similar abuses, or near abuses may occur when nonprofits stretch certain of the special exceptions beyond their breaking point. In addition, we have all recently heard stories about excessive and unreasonable salaries. The way to deal with these problems is not to change the law, which makes good sense, but to beef up the service.

We would support such action if an examination reveals significant abuses in this area. I conclude where I began. The nonprofit sector is too valuable to our country to be the target of legislative action without first making a thorough examination. Thank you.

[The statement of Mr. Swords and a subsequent submission follow:]

Statement By

PETER SWORDS
Executive Director, Nonprofit Coordinating Committee of New York

HEARINGS BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 22,1987

These hearings have been called to review the unrelated business income tax[1] prompted by a perception that tax-exempt organizations have greatly increased their income-producing activities and the suspicion that some of this activity has not been appropriately taxed. Much of this concern has been stimulated by the work of the Business Coalition for Fair Competition which has been working assiduously since the early 1980s on a nationwide basis to advance their contention that tax-exempt nonprofits have an "unfair" competitive advantage over small businesses.

Very little is known about the extent of current income-producing activities by nonprofits. Unlike the commercial world, there has been little economic incentive to investigate this wide and variegated sector. Some anecdotes are repeated and a public relations campaign has been waged which is long on rhetoric and short on facts and cogent analysis. Before any serious consideration should be given to making legislative changes, a careful and comprehensive examination should be made to find out exactly what is being done. Over the years, the nonprofit sector has provided leadership in solving some of the country's most intractable problems. Always at the vanguard of human services, the sector has also, to name the most obvious instances, produced the Salk vaccine, teacher pension plans and cancer research. To move in an area that has made such vital contributions to our country without an adequate information base would be a grave mistake.

It is only "unrelated" business that is subject to the UBIT, and not income from "related" activities.[2] This differentiated treatment is sound and has worked well since it was introduced in the early 1950s. Critics of the tax argue that the distinction between related and unrelated has become blurry, and that many unrelated activities have been characterized as related and thus have avoided the impact of the tax. It is not at all clear what is being said by such arguments. What is clear is that a number of valuable goods and services are being provided to users and consumers at affordable costs. Is it the suggestion of these critics that these costs should be increased so that the private sector's bottom line can be improved? The fact is that to date no one has said what they mean by "competition" nor have they said who would be benefited by the elimination of such so-called "competition" by nonprofits -- the consumer or the seller of the goods and services? The most extreme version of this position argues that only "donative" nonprofits, ie., those that rely largely on contributions for support, deserve tax benefits. Underlying these efforts is the hope that nonprofits will be deterred from engaging in these activities and consequently leave the field open exclusively to for-profit concerns. At bottom what appears to be objected to is the provision of any services or products by nonprofits that could conceivably be sold in a market place.

---

[1] The unrelated business income tax refers to the tax imposed by sections 511-514 of the Internal Revenue Code of 1986, comprising Part III(Taxation of business income of certain exempt organizations) of Subchapter F(Exempt Organizations) of Chapter I(Normal Taxes and Surtaxes).

[2] Generally, a "related" activity is one that advances the exempt purpose of the organization,e.g., a museum selling art books, and an "unrelated" activity is one that has nothing to do with the organization's exempt purpose, e.g., a law school running a spaghetti factory.

To tax the related income of our nonprofits for the first time in the federal income tax's long history would be disruptive and might very well cause major social dislocations. Independent nonprofit universities and schools have been charging tuition from their inception, and the wisdom of that policy has never been questioned. The same thing can be said for nonprofit hospitals charging fees and nonprofit symphony orchestras, theaters, and the like charging admission fees. These receipts have been part of the vital support that allows these institutions to function. In most cases where fees are charged, the service is subsidized to a significant extent. For example, tuition at many private universities pays for about one-half the costs of a student's education and similar expense relationships exist at many of our cultural and human service organizations. Our decision not to tax these receipts stems from the long-held premise of Anglo-American public finance that financial support to pay for the expenses of government, i.e., taxation, should be drawn only from income used to benefit private individuals and business profits, and not from income that is dedicated to the public good. Nonprofits are owned, in effect, by the community and no one invests in them for their private benefit. If the earned income of nonprofits was subject to tax, the natural result would be for nonprofits to shift the burden of this tax to their beneficiaries or to reduce the level of their services. As the services provided by these nonprofits are widely recognized as contributing substantially to our social welfare, a tax that would have the effect of reducing the number of beneficiaries would be negative.

It is sometimes suggested that the tax on related income be limited to those parts of a nonprofit's operation that are self-sustaining or produce net income. These parts are sometimes referred to as "profit-centers." However, it is a mistake to separate them from the entire operation of which they are a part. In fact, the funds which they generate are used to subsidize the other elements of the nonprofit's operation which are not in any way self-sustaining, including being supported by contributions. If we tax a portion of the organization's income allocated to these revenue generating elements, the other parts would be left with less support and the integrity of the organization's overall effort would be substantially diminished.

There are cases where there is reliable and uncontested information that shows the inability of the for-profit sector to provide adequate levels of service in areas traditionally conducted by nonprofits. A recent report for the Comptroller of the State of New York details the abuses made by for-profit business schools in New York. These proprietary business schools are referred to as "registered business schools". The report found evidence of the use of unlicensed sales agents to recruit students for these schools, the admission of students who did not meet admission requirements and a number of other violations. The report concluded that: "These violations along with 'front loaded' tuition charges and high drop out rates ...result in a registered business school being able to substantially increase its profits to the detriment of the educational program."[3] In this regard a cautionary lesson may also be drawn from the experience with for-profit hospitals. After a fast start in the late 1970s, the number of for-profit hospitals has recently declined, presumably leaving gaps in areas of medical coverage.

Finally, it is a short step from maintaining that earned income, or profit-center earned income, ought to be taxed, to concluding that all income, including passive income, ought to be taxed. "Passive income" refers to such receipts as interest, dividend, rent and royalty income. Special provisions of UBIT exempt this income on the grounds that investing in passive income investments does not involve nonprofits in competition with other firms. Subjecting passive income to tax would be ruinous to many of our nonprofits and result in the reduction of goods and services provided by such institutions. As a result the costs of these goods and services, both to the consumers and to the government, would increase dramatically.

The present distinction between "unrelated' and "related" income makes good sense and should not be abandoned, since to do so would be to subject the related income of nonprofits to tax with the resulting dislocations earlier described. It may be that mistakes have been made in characterizing a particular activity as related when it should have been classified as unrelated. It may be that some organizations have attempted to take advantage of the potential for abuse in this area. But these abuses do not argue for the elimination of the distinction. If it is found out that there is a problem here, the solution would be to strengthen the regulatory mechanisms to eliminate the abuses and not to tax all the earned income receipts of nonprofits, whether they are related or unrelated.

Let me turn next to the highly charged question of "unfair" competition. Here perhaps even more than in the previous question, we have no hard information, but only various anecdotes that hardly serve as a basis for shaping national tax policy. This is a most significant area where comprehensive and extensive data is needed before anyone can begin to make sound policy judgments. There are some points, however, that should be kept in mind as we proceed. The claim of "unfair" competition must be based on one of two possible contentions. First, that nonprofits, aided by being exempt from taxation, reduce their prices below those charged by for-profit concerns operating in the same field in order to garner a larger share of the market. Second, that nonprofits, again aided by their tax exemption, enter the market causing an increase in the supply of the goods and services provided in the market and a consequent reduction of prices.

We know of no instance where an organization under the control of a nonprofit has cut prices below the prices charged by taxable firms in order to achieve a larger share of the market. If after a thorough examination of the so-called "unfair competition" or, perhaps more accurately, "the costs of consumer services" problem, it turns out that there are examples of such predatory or near predatory behavior, that will indeed be significant. We believe, however, that this will not be the case. Common sense suggests that it is very unlikely that nonprofits, hard pressed for revenues, would engage in such highly risky behavior. These kinds of predatory practices would diminish current income critically necessary to the maintenance of their operations and run the risk of losing the income source altogether. Certainly the examples that have been so widely publicized -- YMCA heath centers, university bookstores, sheltered workshops, hospital pharmacies -- are the farthest things from predatory attempts to corner the market.

---

[3] See Staff Study of the Tuition Assistance Program for Registered Business Schools, Office of the Comptroller (July 8, 1986).

If the issue is not "unfair" competition through predatory price cutting, then what about the claim that there is excessive entry by nonprofits in some markets with the result that the amount of goods supplied to such markets has increased with a resulting lowering of prices. This is an area of extreme significance in our view because, if "unfair" competition in fact exists at all, it is likely to be of this sort. A number of important questions must then be kept in mind. First, did the complaining for-profits enter the particular market in question before or after nonprofits initiated and developed the enterprise? Certainly, if the for-profits came into the market after the nonprofits, there can be no legitimate complaint because the for-profits should have anticipated whatever competition the nonprofits might provide. We might note that the YMCA health center problem would seem to be a clear example of for-profit post-entry. We believe that some of the other noted examples of "unfair" competition also fall under this category.

What about the case where nonprofit providers enter the market after the for-profit businesses have established themselves? Here extreme care is required. When such a claim is made, the particular market must be examined to ascertain whether the nonprofits entered it in sufficient number to cause supply to significantly increase. Second, it must be determined whether the existing for-profit firms were earning merely competitive rates or enjoying supercompetitive returns, i.e., quasi-rents, because of their semi-monopoly position. If the latter is the case, then the entry of nonprofits into the market merely operates to make it more competitive and efficient and redounds to the ultimate benefit of its consumers. Sound public policy will surely not attempt to discourage the efficient provision of services to the consumer. We believe that most claims of "unfair" competition will on careful analysis be found to involve cases where nonprofit entry has not caused prices to drop below competitive levels. They have merely been reduced to more competitive levels and have not left for-profit firms earning subnormal returns. This suggests that the real ground of the attack on nonprofits is the objection to any competition whatsoever and not merely instances of so-called "unfair" competition.

The present attack on the nonprofit sector could not come at a worse time. As is well known, because of pressures on limited federal resources, the last decade has brought significant reductions in the level of federal aid to many nonprofits. These facts have been documented by the Urban Institute in its report The Nonprofit Sector and the New Federal Budget.[4] One hardly needs to be a social scientist to notice that the conditions of our urban poor are palpably worsening. In New York City, the head of the Human Resources Administration has recently predicted that the level of homeless in our city, already appallingly high, will rise by about 20% next winter. All of this has put enormous pressures on our nonprofit sector in its attempts to respond to the human problems caused by these reductions in federal funding. Indeed, from the start of his administration, our President has explicitly and repeatedly asked that the sector step in to fill the gap. Demands on traditional sources of non-government funding for nonprofits, such as private foundations and individual contributions, have been overwhelming. Recent changes in the federal tax code that may reduce charitable contributions by billions of dollars have also made things more difficult. It would hardly be surprising, then, if nonprofits have prudently developed alternative income sources through the sale of appropriate goods and services. To diminish such alternatives through inappropriate taxation would result in one of two things.

---

[4] Alan J. Abramson & Lester M. Salamon, The Nonprofit Sector and the New Federal Budget (1986). See also, Abramson & Salamon. Government Spending and the Nonprofit Sector in New York City (1986).

Either the government would have to increase its level of funding to these organizations and so raise taxes, or current services would have to be eliminated. Either of these alternatives is materially less desirable than present circumstances.

As has been suggested, much of the criticism of nonprofits has been aimed at their "related" activities such as retail gift shops in museums, university travel services and book stores, and health facilities run by YMCAs. We have suggested that when a careful study of this area is done we believe that it will be found that these activities do not compete unfairly. But there is an important and obvious point to make about these efforts quite apart from the competitive aspects. We believe that these earned income ventures arise because nonprofits have staff with special expertise, facilities, and a population of consumers which makes the initiation of these activities natural, if not inevitable. Who could be better suited to select books on art for a museum gift shop than its curators, and what better population could there be to buy these books than those who visit the museum? An identical analysis can be applied to university bookstores, hospital pharmacies, and other health-related services provided by hospital complexes. Similarly, there are periods during the year that many educational institutions are closed and their facilities and personnel are available for activities that do not involve their regular students. In other words, these related activities do not involve nonprofits opening up new lines of activities that have nothing to do with their basic function or primary reason for being. There is no question of talent and energy being redirected from an organization's exempt purposes to the merely commercial, with a correlative shift in motives and values. These related activities make available to the public important goods and services in a way that is highly efficient. In many instances these income-generating activities, whether by hospital pharmacies, university research centers or retail gift shops, represent an optimum use of the nation's resources.

Let me end where I began with the strongest possible plea that we do not act reflexively in ignorance. At the moment there is much confusion over what we mean by "unfair" competition and no systematically gathered evidence to indicate whether or not it exists. Self-interested complaints and a few anecdotal illustrations are not enough to base a national policy on. A careful and comprehensive examination must be conducted to gather the facts. The excellent reports prepared by the Treasury Department in the mid-1960s that led up to the Tax Reform Act of 1969, a piece of legislation the virtues of which grow more self evident with each passing year, are examples of what should be done. To tax sources of income derived by nonprofits that are now exempt could very well impose irreparable damage on one of the most important elements of our national polity. Such information has not been gathered and it is clearly the task of this Committee to take whatever steps are needed to see that it is. One step that could be helpful in the future would be the introduction of disclosure procedures, similar to those which now apply to private foundations, so that information about the valuable work performed by the nonprofit sector could be made available to those who seek it and public confidence in the sector, so richly deserved, could be enhanced.

NONPROFIT COORDINATING COMMITTEE OF NEW YORK

RECEIVED
AUG 31 198
Ways and M
Subcommittee on O

August 25, 1987

Ms. Rusty Guritz
Subcommittee on Oversight
House Ways and Means Committee
1105 Longworth HOB
Washington, D.C. 20515

Dear Ms. Guritz:

We sent the enclosed Survey Form with covering memo (copies enclosed) to all of our 200 members. As of this date 83 have responded. Only 8 of these 83, or about 10%, indicated that they conducted income producing activities, the income of which is subject to the Unrelated Business Income Tax. None of these 8 reported receiving any complaints from for-profit organizations regarding these activities. (However, one of the 8 answered Question #3 as follows: "Yes, but not recently. There were such complaints about the gerage in the mid-1970's and about hall rentals and catering in the late 1960's to early 1970's." One of the 75 that reported no UBIT answered Question #3 as follows: "[T]here has been one complaint re: the possibility of our re-establishing a facility in a neighborhood where we have always run programs, but do not currently have a building -- having sold the one we had at a prior time.")

Of the 8 organizations reporting unrelated business activities, the amounts of gross income ranged from $531,500 to just over $2,000. Three of the 8 reported no unrelated business gross income apparently not understanding the question or failing to be attentive to the difference between "net" and "gross" income. Of the 5 reporting unrelated business gross income the median amount reported was $168,500. Only one of the 8 reporting unrelated business activities reported taxable income and that was in the amount of $15,500. Many of those reporting gross income indicated that their expenses exceeded their income.

In terms of excepted or excluded income, of the 8 reporting unrelated business activities, 6 reported passive income usually specifying dividends and interest and realized capital gains. One of the 75 reporting no unrelated business activities reported dividend and interest income.

Answers to the question eliciting information about excepted or excluded income (Question #2(c)) included information indicating that 6 organizations sold publications of one sort or another (3 from the sub-group of 8 and 3 from the sub-group of 75), one had a gift shop, restaurant and garage operation (from the sub-group of 8), and one had a small gift shop (from the sub-group of 75).

I believe our membership is quite representative of the entire New York City 501(c)(3) nonprofit sector. It contains human service groups, art and cultural groups, health care groups, foundations, religious groups, educational institutions and organizations devoted to better government. They range from very large institutions, like major universities or museums, to small store front organizations.

I will let you draw your own conclusions from this data. I would like, however, to make the obvious point that it dramatically shows why those of us who work in the nonprofit sector have a wholly different view about the importance of the problem than that manifested by the Business Coalition for Fair competition and related small business groups.

I hope you will share this letter with Chairman Pickle and that you will both find it of some interest. If you have any questions with regard to it, please feel free to contact me. If more forms are returned I will update as appropriate.

Sincerely,

Peter Swords

Peter Swords
Executive Director

enc.

July 15, 1987
TO: Nonprofit Coordinating Committee Members
FROM: Peter Swords, Executive Director

SUBJECT: House Way and Means Oversight Subcommittee
Unrelated Business Income Tax Hearings

On Monday June 22, I participated in a panel that gave testimony to the House Ways and Means Oversight Subcommittee on the unrelated business income tax. A copy of my testimony is enclosed. The panel included the Independent Sector, the National Assembly of Voluntary Health and Social Welfare Organizations and some small business groups. After we completed our testimony, Chairman Pickle asked me how many of NPCC's members paid the unrelated business income tax (UBIT). My response that I did not have the information appeared to disappoint him because the Committee needs data to determine whether or not there is need for a change in tax policy. No one seems to have this data yet. He also asked whether any of our members had been the subject of complaints from for-profit businesses. Therefore, I am writing to you to find out whether your organization pays any UBIT and whether you are aware of any complaints from for-profit concerns that you are competing with them. After this survey is completed I intend to send its results to Chairman Pickle. This will be done in aggregate form, presented in a manner similar to what follows: "Of the 150 organizations which responded to our survey, 2 pay UBIT". No individual organization will be identified.

UBIT is a tax that is imposed upon the unrelated business income of tax exempt nonprofits. "Unrelated" business is business that is carried on by a nonprofit that does not contribute importantly to its exempt function. The classic example is the macaroni factory that the N.Y.U. Law School used to run. "Related income", however, is not subject to tax. Related income is income derived by an exempt organization from carrying out its exempt function, e.g., tuition charged by a university, fees charged by a hospital or admission charged by a nonprofit theatre. Another way of illustrating distinction between "related" and "unrelated" is to consider a museum retail shop. If it is part of an art museum and the shop sells books on art and books on science, the income from the sale of books on art is "related", and the income from the sale of science books is "unrelated". If an organization is subject to UBIT, it must file with the Internal Revenue Service Form 990-T as well as Form 990. Most groups do not engage in unrelated businesses and so do not have to file the 990-T or pay the tax.

Please fill out the enclosed questionnaire and return it to us in the enclosed self-addressed envelope. As indicated, this information will be kept strictly confidential. In this regard, you will notice that the questionnaire requests no identification.

If you have any questions about this, please do not hesitate to call me at (212) 689-1240.

Thanks for your help.

NPCC UBIT Survey

1. Does your organization engage in any income producing activities the income of which is subject to the unrelated business income tax?
(Note if the answer to this question is "yes", a Form 990-T - "Exempt Organization Business Income Tax Return" - will have been filed on your organization's behalf. Further, just because an organization filed a 990-T it does not mean it paid a tax. It may have had expenses that equaled or exceeded its unrelated business income. Nevertheless, if a 990-T was filed, the answer to this question should be "yes".)

______

2. If the answer to 1 is "yes",

(a) How much unrelated trade or business gross income did your organization report?
(The amount reported on Line 1 of your 1986 990-T.)

$______________

(b) How much tax did your organization pay?
(The amount reported on Line 15 of your 1986 990-T.)

$______________

(c) What major sources of income, if any, are excepted or excluded from the unrelated business income tax?
(Income from trades or businesses substantially all of the work of which is done by volunteers, or which sells merchandise substantially all of which has been donated, or which is carried on for the convenience of its members, students, patients, officers or employees is excepted from the UBIT. Also, "passive" income is excluded from UBIT. Passive income includes dividend, interest, rents and royalty payments.)

____

____

3. Has any for-profit organization complained that the activities that your organization engages in competes with their interests?

______

Chairman Pickle. Thank you. We will hear next from Dr. Earl Hess from the U.S. Chamber of Commerce.

STATEMENT OF EARL H. HESS, PH.D., MEMBER, BOARD OF DIRECTORS, AND MEMBER, COUNCIL OF SMALL BUSINESS, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE, ACCOMPANIED BY DONALD C. BERNO, U.S. CHAMBER OF COMMERCE

Mr. Hess. Mr. Chairman, members of the subcommittee, thank you very much for the opportunity to appear before you today. We have submitted, for the record, a rather complete statement on the subject, and my remarks this afternoon will be a short summary of those.

I guess before plunging into those, I would like to make one or two incidental observations, however. First, I am glad that I am not the last witness on the last day or there probably would not be anything more to be said.

Second, however, I think maybe, as being the last witness today I might have something to say, because I probably am the only one that has appeared today so far, that has felt the sting of nonprofit competition in the middle of my gut, in the first person.

And maybe I can add some dimension there. My industry is one of the six that was cited in the GAO report.

I am president of Lancaster Laboratories, Inc., a high-technology analytical services firm which I founded in 1961. Beginning with one employee besides myself and my wife, we have grown steadily to a current level of about 200 employees.

Our staff consists mainly of chemists and biologists who serve the national needs of business, Government, and private citizens in the area of food-testing, pharmaceutical, and environmental analysis.

One of the major challenges to my business's growth and development over the years has been the intrusion of academic scientists into the commercial marketplace. They have the advantages of low or nonexistent overhead, with equipment often obtained through grants or gifts. They pay few, if any, of the many taxes to which I am subject, and they further benefit immeasurably from what was to be called the halo effect, granting them de facto technical credibility and immunity from any conflict of interest questions.

Further, the users of their services acquire their testing at low fees, while being told that they are contributing to a worthy cause. All this adds up to having a business competitor that is pretty tough to deal with and also pretty hard to respect.

Today, as a member of its board, I am pleased to represent the thousands of small business persons who are members of the U.S. Chamber, either directly or through membership in one of its 4,000-plus member trade associations.

These entrepreneurs are collectively the "movers and shakers" in our country's economic system. They are not asking for any handouts or special privileges. They are willing to take risks far beyond those taken by any other segment of our society, except perhaps for U.S. politicians.

Their request on this issue, as it echoes from the 1980 and 1986 White House Conference, is simply for justice and fairness. They do not wish to dislocate the many legitimate nonprofit tax-exempt organizations serving crucial needs of our society, but they are objecting when nonprofit tax-exempt status is used as a structure for unfair advantage in the world of commerce.

My written testimony treats various aspects of the nonprofit question. It makes the point that most nonprofits are not being called into question by small business, and it deals specifically with the need for more information from nonprofits on which to base any judgment of legitimacy.

It also deals with one of the major reasons for the failure of the unrelated business income tax to solve the fairness question, the question of relatedness.

I have witnessed some of the most far-fetched rationales to relate the commercial activity to a nonprofit's tax-exempt purpose. One common example in my testing business is the university professor engaged in purely commercial testing. When challenged, he glibly replies he is collecting data for his "research".

UBIT is simply not working, and in large part because of the vagaries of the relatedness test. I challenge you, as lawmakers, to develop alternate tests for 501(c)(3) status. Those of us concerned about this issue in Pennsylvania are returning to the language of our State constitution that says something about purely public charity for guidance in our efforts.

In conclusion, I would like to answer one question that you would surely ask me. How can you be so concerned about your tax-exempt competition while your own business is growing so rapidly in spite of it? I can say that I am fortunate, presently, to be in a business whose marketplace is expanding.

Many of my small business colleagues are in markets that are not growing, and they are having to retrench, and in some cases, being even forced out of business. As I mentioned earlier, it is not our purpose to damage legitimate tax-exempt organizations who are serving a public interest role, but neither can I stand idly by and witness the demise of my small business colleagues who also serve the public interest through the products and services they provide, the jobs they create, and the taxes which they contribute to our society.

Thank you very much, Mr. Chairman.

I would like to, before closing, point out one technical error in our testimony. Page 4, paragraph 2, where the expression 501(c)(3) is used. It would be more appropriately to simply say "tax-exempt", and if you would make that correction I would appreciate it.

Chairman PICKLE. Without objection.

Mr. HESS. I did want to mention, too, that joining me today is Mr. Don Berno of the U.S. Chamber Small Business Center who is seated right behind me, and might help in answering any questions.

[The statement of Mr. Hess and letter subsequently received from Mr. Berno follow:]

TESTIMONY
on
NONPROFIT COMPETITION WITH BUSINESS
before the
SUBCOMMITTEE ON GENERAL OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. CHAMBER OF COMMERCE
by
Dr. Earl H. Hess
June 22, 1987

I am Earl H. Hess, President of Lancaster Laboratories, headquartered in Lancaster, Pennsylvania. I am appearing today on behalf of the U.S. Chamber of Commerce. I am a member of the Board of Directors of the Chamber and I also serve as the Chairman of the Legislative Policy Committee for its Council of Small Business. I am very pleased to have the opportunity to testify before you on the impact of nonprofit competition on businesses and on the U.S. economy.

I have observed many instances of nonprofit competition with small business, from many different perspectives, in attempting to deal with this growing problem over the past 15 years. I am president of a small, but growing, independent laboratory, and I am, or have been, a board member and officer in chambers of commerce at the local, state, and national level.

Furthermore, I am a past president of my industry's trade association, the American Council of Independent Laboratories, and an active leader in tax-exempt church, community, charitable, and educational organizations in my state and community.

The Chamber opposes the unfair competition engaged in by some tax-exempt organizations with business, while recognizing the legitimate and important role played by most tax-exempt organizations. The Chamber has long-standing policy that each type of lawful enterprise "should stand on its own merits with protection from unfair competition."

The Chamber believes that unfair, nonprofit competition with business is a significant and growing problem that most injures those businesses that are most vulnerable: small businesses.

At the same time, only a small number of tax-exempt organizations compete at all with business. Therefore, the Chamber commends this Subcommittee for using the resources at its disposal to begin the difficult task of identifying those specific tax-exempt sectors which have used their tax-exempt status and other benefits to engage in commercial activities in unfair competition with small business.

The Chamber is a nonprofit organization operating under Section 501(c)(6) of the Internal Revenue Code. It is composed of over 180,000 members--large and small businesses, trade and professional associations, and chambers of commerce. I will describe the membership of the Chamber and its different perspectives on the issue of nonprofit competition later in my statement. Approximately 90 percent of the Chamber's members are small, independent businesses with fewer than 100 employees. These businesses contribute more than 70 percent of the Chamber's revenues, and they are the driving force not only of the U.S. economy, but also of business organizations such as the Chamber and most of the 4,000 nonprofit business organizations that make up the U.S. Chamber of Commerce Federation.

The Chamber, as a representative of the business community, has no interest in shielding any of its members, large, small, or nonprofit, from competition. The Chamber stands for full and open competition, with limited government involvement in setting the basic rules, allowing private enterprise and individual initiative to solve most of society's problems, and providing the goods and services that the consumer wants.

My experiences with two White House Conferences on Small Business and a number of trade associations lead me to believe that most small business people who have been affected adversely by nonprofit competition join the Chamber in strong support of the unique voluntary, philanthropic system within the U.S. Our system shines as a beacon to the rest of the world, highlighting our respect and concern for the dignity of individuals.

The voluntary philanthropic system in the U.S. complements an even more important system that has allowed more people to live with dignity and freedom than any other system in the history of the world--the free enterprise system.

We support the important role of tax-exempt organizations in addressing their members' needs and society's problems. However, we are concerned about the growth and diversification into "commercial" activities of some of the largest groups of Section 501(c)(3) organizations.(1) Specifically, I am referring to the activities of some nonprofit hospitals, other health care institutions, research organizations (including some museums), educational institutions, alumni associations, and religious organizations.

My experiences have convinced me that this problem can be alleviated without significant injury to the important function of tax-exempt organizations.

The Chamber believes that, over the past 40 years, federal laws have introduced various tax exemptions and subsidies that have had the unintended consequence of encouraging entire new groups of Section 501(c)(3) organizations to be formed, and encouraging some existing Section 501(c)(3) organizations to expand and diversify into nontraditional enterprises for the primary purpose of earning tax-exempt income to support their other activities.

---

(1) Organized as specified under Section 501(c)(3) of the Internal Revenue Code. Hereafter referred to as 501(c)(3) organizations.

I. Profile of Tax-Exempt Organization Activities

A. Introduction

A review of the macroeconomic statistics of tax-exempt organizations makes a compelling case for the Subcommittee to be conducting these oversight hearings. This is a large and rapidly-growing sector of the economy.

The U. S. has a history of encouraging philanthropy and voluntary initiative to aid people to perform activities that businesses either can not or will not do directly. Certainly, this tradition has motivated much of the growth in the nonprofit sector since the 1940s. 870,000 tax-exempt organizations filed tax returns with the Internal Revenue Service (IRS) in 1982, a 100 percent increase over the 400,000 plus nonprofits that filed in 1962, and an 800 percent increase over the approximately 100,000 nonprofits that filed information returns in 1946.

It is a law of economics that to encourage behavior you provide incentives for it, and to discourage it you provide disincentives for it. Since the 1950s and earlier, national policy in the U.S. has provided incentives for nonprofits, particularly 501(c)(3) organizations. This has encouraged formation of new nonprofit organizations and fueled the growth and diversification of existing organizations, particularly in the education, health care, and research sectors. On the whole, this has been good for our society, but it has led some 501(c)(3) organizations into commercial activities.

An example of incentives provided by the government for 501(c)(3)s involves payroll taxes. Certain nonprofit organizations can elect to exclude themselves from some payroll taxes. However, since the 1950s, taxes on business, particularly payroll taxes, have increased, thus giving these nonprofit organizations a competitive advantage with businesses--particularly in the areas of education, health care, and research. This Subcommittee is well aware of the concerns of small business with payroll costs. This exemption is a major factor in bringing the problem of unfair competition to a head, as taxpaying businesses and tax-exempt organizations increasingly compete to provide the technical and recreational services demanded by customers in our changing economy.

B. Rapid Growth of the Tax-Exempt Community

A 1987 General Accounting Office (GAO) Study(2) describes in detail the growth of the tax-exempt sector and the spread of some nonprofits into commercial activities. "The tax-exempt or nonprofit community has increased over the years in terms of number of organizations, statutory tax-exempt categories, types of activities, and resources. It now represents a diverse set of organizations ranging from rather informal social or neighborhood clubs with limited resources, to complex multimillion dollar medical complexes, educational institutions, and fund-raising organizations. . . .

"The number of statutory tax-exempt categories also has continued to increase, growing from 15 in 1946 to 25 in 1986. As the number of categories has increased, so has the number of specific exempt activities within these categories. IRS listed 90 different tax-exempt activities in 1965, but now there are over 260 such activities. Further, many tax-exempt organizations engage in more than one activity. . . .

---

(2) "Competition Between Taxable Businesses and Tax-Exempt Organizations," February, 1987, Briefing Report to the Joint Committee on Taxation, U.S. Congress, General Accounting Office (hereafter, "1987 GAO Study"), p. 31.

While many of these appear to be traditional charitable-type activities, such as missionary and fund-raising activities, others appear to be more similar to taxable businesses in nature." (1987 GAO Study, at p. 14.)

"The tax-exempt community has sizeable financial resources and continues to increase as a share of the national economy," up from 1.3 percent of Gross National Product (GNP) in 1930 to 3.3 percent, or $131 billion in 1985, according to a U.S. Department of Commerce estimate. (1987 GAO Study at p. 15.) Other estimates have placed the tax-exempt sector's share of GNP as high as 9.0 percent, or $300 billion.

The GAO study also indicates that the tax-exempt community is dominated by "Section 501(c)(3) organizations"--educational, health, charitable, and religious. Within this category, educational and health organizations are the largest and the most rapidly growing, representing 53 percent of Section 501(c)(3) revenues in 1975.

Although there are many small, community-based nonprofit organizations, the tax-exempt community is, in reality, highly-concentrated, and is dominated by a small number of large organizations that control the majority of total tax-exempt community resources. Whereas only one percent of all tax-exempt organizations filing reports with the IRS had an annual revenue of $10 million or more in 1975, this small group accounted for $68.9 billion, or 60 percent, of the tax-exempt community's total revenue that year. Again, health and educational organizations dominate this group.

It should come as no surprise that health and educational organizations dominate the tax-exempt sector. They perform extremely important, costly, and complex services, and they receive the most generous subsidies and tax exemptions. All income from research done for the government or done by colleges and universities for other groups is tax-exempt income under current federal law. Similarly, tax-exempt hospitals and related health care institutions receive generous exemptions and subsidies under federal law. These are irresistible incentives for many universities, hospitals, and other exempt organizations, particularly those experiencing financial difficulty, to expand their research activities into commercial areas.

In addition to this growth, entry into nontraditional businesses, and concentration of resources in health care and educational fields, one more point needs to be made about the tax-exempt sector: it is becoming increasingly reliant on income-producing or commercial activity. The 1987 GAO study found that revenues from sales of goods and services represented 75 percent of the income of tax-exempt organizations in 1978, up from 57 percent in 1946.

We should not conclude from this profile that tax-exempt organizations need to be regulated strictly or desolved, or that the concentration of their resources in a small group of organizations is harmful. The biggest nonprofit organizations are some of the best-known and important institutions in our society: the Sloan-Kettering Hospital, National Geographic magazine, United Way, the State University system, and the Smithsonian Institution.

However, we must recognize that these important and respected institutions must regulate their own expanding activities carefully and must concentrate on their missions rather than on their ability to sell commercial goods and services.

Because competition from some large and small tax-exempt organizations is national in scope, but local in application, many small businesses are not even aware of the lost opportunities and growth that this competition has cost them.

C. The Response to Competition by Tax-exempt Organizations with Business

The Chamber is joined by a growing number of business organizations and businesses that believe that this is a serious and growing problem deserving review and redress by policymakers.

The Chamber is a member of the Business Coalition for Fair Competition (BCFC), a group of 29 trade associations whose members have and are experiencing unfair competition or being injured by unfair nonprofit competition.

BCFC and other business organizations and businesses will be providing specific examples during these hearings of the types of competition they are facing. However, we do want to summarize the reactions of small businesses to the problems posed by nonprofit competition.

The 1987 GAO report surveyed 1700 businesses in six industries--independent research, racquet sports, veterinarian, travel, tour, and audio-visual communications--and found that nonprofit competition is a significant problem for each industry. 84 percent of the research businesses, 90 percent of the racquet sports businesses, 64 percent of the audio-visual companies, 61 percent of the veterinarians, and 45 percent of the tour companies and travel agents reported that they were experiencing competition from one or more tax-exempt organizations. A majority of the respondents in each category believe that the problem is getting worse. (1987 GAO Study, at p. 35.)

Additionally, the 1986 White House Conference on Small Business's number three recommendation was to eliminate tax exemptions and subsidies for the commercial activities of nonprofits and monitoring by the Small Business Administration Office of Advocacy and the Office of Management and Budget of government regulations that subsidize nonprofits. The Chamber Board endorsed this recommendation last November. The Council of Small Business, the Chamber of Commerce Committee, and the Association Committee currently are meeting to develop specific solutions to implement this recommendation.

II. The Purpose of the Unrelated Business Income Tax Law and Its Administration by the IRS and the Courts

In applying federal tax law, the interpretation and application of the unrelated business income tax (UBIT) is very important. The UBIT law was enacted in 1950 to deal with the very specific situation of a tax-exempt organization operating an unrelated business that had been given to it. As the 1987 GAO study indicates, the UBIT law is difficult to administer, according to IRS officials, because there are no concrete rules for determining relatedness of income-producing or commercial activities to an organization's exempt purpose.

The UBIT law requires that for income to be taxable it must be "derived from the conduct of a trade or business," "carried on regularly," and "not substantially related to the purpose for which the organization was granted an exemption." The "substantially related" requirement presents the greatest difficulty. The courts, in analyzing whether the activity is related, look to all the facts and circumstances of the activity and the organization. If the activity is "related" to the purpose, then the income is exempt, no matter how large the income or how devastating the income-producing activity is to the economic interests of a competing for-profit business.

The difficulty in determining "substantially related" has led to some arbitrary distinctions, such as a tax-exempt zoo having to pay tax on income from the sale of animal jewelry but not stuffed animals, which are considered related to its mission and, therefore, exempt. In looking at the facts and circumstances of the activity, it would seem that the commercial nature of the activity, and whether the same activity can be provided by a taxpaying business, should be taken into account in determining whether the income from the activity is tax-exempt. This additional factor in the "substantially related" provision is one of the solutions which the Chamber currently is examining.

The Chamber believes that the ongoing public demand for simplifying taxes and regulations--making them fairer and designing and implementing them to have the least impact on economic decisionmaking --should apply to the UBIT tax as well.

III. Compliance With The Unrelated Business Income Tax

The IRS has only 500 agents to monitor and enforce the UBIT law, which as described above is extremely difficult to interpret and apply. The ratio of 500 agents to more than 870,000 nonprofit tax returns seems inadequate. However, adding many more agents, without changing the law and regulations, probably would not lead to better enforcement.

Additional resources would be better spent in improving the IRS's data base on nonprofit organizations, requiring more detailed tax returns from some Section 501(c)(3) nonprofits which would specify the nature and source of income, and the allocation of expense to offset that income.

IV. Conclusion

This issue of unfair competition between 501(c)(3)s and taxpaying businesses is an important issue for the Subcommittee. The Chamber supports the charitable goals of 501(c)(3)s and sympathizes with their efforts to provide as many services as possible to those in need. We also are concerned, however, that the actions of a few 501(c)(3)s who enter into commercial activities unintentionally may damage another sector of our economy--small business.

The Chamber believes that the different groups with an interest in this issue--small businesses, the tax-exempt sector, legislators, and Administration officials--need to work together to fashion a better method of distinguishing taxable and tax-exempt activities and income. These improved distinctions will allow for-profits and nonprofits to continue their important contributions to our society.

RECEIVED
JUN 30 1987
Ways and Means
Subcommittee on Oversight

U.S. CHAMBER OF COMMERCE

Small Business Center
Business-Government Policy Department

June 26, 1987

The Honorable J.J. Pickle
Chairman
Subcommittee on Oversight and Investigations
Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Pickle:

The U.S. Chamber again congratulates you for holding hearings on a problem of growing importance to the small business community -- unfair competition by nonprofits.

As you may know, the U.S. Chamber membership comprises all sectors of the business community -- big business, small business, trade associations, and state and local chambers of commerce. Because of the broad base of our membership, and outstanding work of your staff in scheduling witnesses from all sectors of the business community, we decided to present a broad overview of the problem. We felt this approach would be helpful to you and other members of the subcommittee and allow the subsequent witnesses of the business community to provide you details of the problem in their own industries.

At this time, I would like to bring to your attention three additional stories of nonprofit competition that have recently come to our attention.

The first two involve nonprofit hospitals. Cook's Ambulance Company in Columbus, Mississippi has provided ambulance service to Lowens County, Mississippi on a competitive bid contract for several years. They have 15 employees. Last year, the county-subsidized hospital obtained an ambulance and has stated publicly that when the county ambulance service is offered for bid again, they will bid $1,000. The second story involves laundry services. The York Hospital in York, Pennsylvania has laundry facilities for doing the hospital linens. Last year, they started doing nursing home laundry that was previously done by a commercial laundry. The commercial laundry was not too upset about that because the cost was lower, and the nursing home, which he supported, was having a tough time financially. But he is upset now that the hospital is doing laundry for a second customer of his -- a local hotel.

1615 H Street, N.W. □ Washington, D.C. 20062 □ 202/463-5503

The final example I would like to offer involves a pallet manufacturer in Lima, Ohio. He has been forced to lower his prices to win contracts in competition with a local sheltered workshop. The workshop is exempt from most wage and hour laws, and uses donated equipment. The combination of lower labor costs and minimal equipment costs provide the sheltered workshop with enormous advantages in competitive bidding situations.

I hope that these examples, when combined with the stories you will hear from the rest of the witnesses will be helpful in your efforts to address this problem.

We look forward to working with you as you proceed on this issue.

Sincerely,

Donald C. Berno

Donald C. Berno
Legislative Counsel

cc: Dr. Earl H. Hess

Chairman PICKLE. I want to thank you, Dr. Hess, and thank all of you. Does this complete the panel now? Everybody has had their say. Let me make a couple of observations or comments, first, with respect to a statement that Marion Fremont-Smith had made with respect to the overall independent sector.

You made a statement, right at the end of your comments, that you have been invited to testify for a balanced inquiry into UBI rules and competition concerned with no legislative agenda.

And that you think you should not testify, or not make any position until that legislative agenda is available. Now if we took that same position with respect to lobbying and political activity, we would not move forward. If we took this same position with respect to a legislative agenda in this particular UBIT field, I do not know that we would ever make any progress.

Now, we are going to hold 5 days of hearings, and we may or may not be able to get a legislative agenda, and I do not know whether you would call it a legislative agenda, or set of recommendations, but we are going to proceed to make our report to the full committee.

And if you have any comments on proposals that may or may not be put together, you are welcome to submit them to us, but I want to now make it plain that you cannot just request a legislative agenda to testify again, because that probably will not be given to you.

I want to be sure that you do not think that you are going to have the "luxury" of several more hearings because that may not be possible.

Now Mr. Swords, you started off by saying that you were alarmed that this was just a public relations scheme only. Whose public relations scheme is it?

Mr. SWORDS. Well, I did not refer to these hearings, Mr. Chairman.

Chairman PICKLE. Well, what did you refer to when you said this was nothing but a PR campaign.

Mr. SWORDS. I was referring to a public relations campaign that has been going on by certain representatives of the small business community since the early 1980's, and I was not referring to these hearings.

Chairman PICKLE. Your statement before the committee, that you were alarmed, because this was really nothing but a public relations campaign.

Mr. SWORDS. Yes. I was not referring to these hearings.

Chairman PICKLE. Well, I would want to make it plain to you, that this committee is holding the hearings because the chairman of our committee has asked us to look into this question over a period of time regarding the proliferation of tax-exempt organizations, the allegation of small businesses, and the findings of the Small Business Administration.

The concern that both IRS and Treasury have expressed to us about the problem we face, had led our chairman to the conclusion that we must look into it again, because we have not looked into this question for 19 years.

That is not a public relations scheme. This is one of the most serious problems that we have, and I would want to make it plain that your allegation is that some other groups are putting on this campaign, but not this committee.

Mr. Swords. Absolutely. Not this committee.

Chairman Pickle. All right, then. You are partially forgiven, then.

Now, I want to ask several questions. Let me see. I will start off with you, Ms. Smith. Even without complete data, and let us assume that we do not have complete data, is it possible or even essential to look at the issue from a tax policy standpoint? Should we look at it from a tax policy standpoint and try to do something about it? Or should you wait for full data?

Mrs. Fremont-Smith. I certainly believe that you should look at it from a tax policy standpoint. I hope, as I tried to indicate, that what will come out of these hearings in terms of tax policy is a reaffirmation of the importance of the independent sector and the need to balance its needs and its position vis-a-vis Government and the business community.

I also believe, and I think I am echoing what Treasury has said, is that to make very specific changes in the basic legislation without understanding, really, what the actual situation is, could do potential damage, not just to the independent sector, but to a large number of programs that Government wants to be conducted by that sector.

It is for that reason that we are asking that you go slowly on specific legislative changes.

Chairman Pickle. What do you think about Treasury's recommendations? They made about seven specific recommendations, suggestions; some of them are rather substantial in nature. What do you think about those recommendations? Did you hear them?

Mrs. Fremont-Smith. Yes, I did, sir. I am very conscious of the fact that I am here as a board member of Independent Sector and I cannot speak for Independent Sector as to those specific recommendations because it is a very large organization that obviously has not looked at them. If I can put on my hat as a tax lawyer, however, it appears that each one of them deals with a subject that warrants study. In other words, if you had asked me to review the statute and identify problem areas which I thought we ought to examine, I think that the Treasury has given you a very important list to consider.

I say that recognizing that Treasury has said—as I.S. also concluded—that the standard of unrelated is probably about the best that we are going to be able to get.

Chairman Pickle. Let me ask you the question again. In general, do you think that the recommendations that Treasury has made today are substantial and should be pursued and should be advanced?

Mrs. Fremont-Smith. Their recommendations to look into the areas? Yes, I do agree. I did not feel that they were saying you should change A this way and B that way.

Chairman Pickle. But just look into them?

Mrs. Fremont-Smith. Yes, they all should be pursued.

Chairman Pickle. All right.

Mrs. Fremont-Smith. In other words, I think they have highlighted the areas that need attention.

Chairman Pickle. Well, now, Mr. Swords, back to you.

Mr. Swords. Yes, sir.

Chairman Pickle. You have indicated that your members are not really hurting the small business, and this is, at least according to them, just a PR campaign. May I ask you what income-producing activities are your members engaged in now? Give me some examples. I would like to know what UBI tax do they pay and on what are they paying it.

Mr. Swords. We have not canvassed our members to find that out, Mr. Chairman. There are a number of human service organizations who charge nominal fees for the services they produce.

Chairman Pickle. You do not know which of your members pay UBI tax?

Mr. Swords. I do not know which one of my members pay the UBIT.

Chairman Pickle. You do not know what they pay.

Mr. Swords. No, sir.

Chairman Pickle. That seems rather strange. You are here to testify.

How many organizations do you represent?

Mr. Swords. Slightly more than 200.

Chairman Pickle. And you do not know whether they pay. Well, I do not know either, but we will find out from your members because I think it would be of interest. But I was just wondering if they were involved in UBIT—and I assume they are. Are they over the $25,000 threshold?

Mr. Swords. Most of them are over the $25,000 threshold. Yes, sir.

Chairman Pickle. You would assume, then, that many of them would be paying UBIT?

Mr. Swords. Those which engage in unrelated business income would be paying UBIT. I do not think many of them do.

Chairman Pickle. Well, I would like to know just as a matter of inquiry. Staff can look into that. I think it would be interesting.

Have any of your organizations gotten complaints from businessmen about the organization's practices?

Mr. Swords. Not that I know of.

Chairman Pickle. Some of the others on the panel, if you want to enter into this, I invite you to do so because I am trying to just see factually rather than just take a statement.

Mr. Cohen. Mr. Chairman, if an organization does not engage in activities that are unrelated, then it does not file an unrelated business tax form even though it may charge for its services.

For example, if a social work agency charges anywhere from $1 to $20 or whatever the fee might be for counseling services, probably below cost, it would not have that problem. Even a museum that charges $5 admission, if you figure it out on a per-capita basis, most museums would have a higher expense than that.

Chairman Pickle. Most of these organizations that apparently belong to Mr. Swords' group are the larger organizations.

Mr. Swords. We have all kinds, the large and small.

Chairman Pickle. Well, here again, I think we have to take an individual look at the companies and the organizations. A lot of this has to be operated on a case-by-case basis. I accept that. That makes it a very difficult matter for us to try to determine what is fair and how can we get a rule that will fit everybody.

I know that is difficult, but that is what we are going to be facing.

Mrs. **Fremont-Smith**. I did not find the statistics presented by the Commissioner surprising in terms of the number of organizations that did not file unrelated business income tax returns. My experience has been that the vast majority of exempt organizations are not interested in engaging in unrelated businesses. They really are attempting to carry out what they consider their exempt purposes.

I think the problems we face and much of the tension expressed in the hearings arise because the small business community is really asking us to define differently what is a related business; they are not as upset about the unrelated activity which is taxed—although they have some concerns about that—but that there are activities that Congress has said will be exempt from tax and they are questioning whether there are proper exemptions.

What is being said is that the traditional activities of exempt organizations that Sheldon Cohen described have never been subject to tax; they have been considered activities that Congress felt it was important to be to encourage. Now, certain members of the community are saying no, that is not right; we want to carry, on these activities, and you should, therefore, reconsider whether it is appropriate that they remain tax exempt.

I think that is the heart of the problem.

Mr. **Motley**. Mr. Chairman?

Chairman **Pickle**. Yes, Mr. Motley.

Mr. **Motley**. I think I would probably agree with that statement to a great extent, but I would also add that the interpretation of the law, what is related and unrelated, is so fuzzy that really that is adding fuel to the fire in terms of the concern of the small business community.

When you have a very thin thread being used, such as the professor at the university who says he is doing the testing for research, to be able to determine whether something is related or unrelated, that is what is driving most of our members a little bit crazy in terms of trying to get a handle on this competition.

Mr. **Cohen**. Mr. Chairman, I do not know what universities are competing with these gentlemen, but I know that most universities impose approximately a 50 percent or greater overhead charge on every professor who runs a research project. That is greater than most small businesses I have seen.

Chairman **Pickle**. Well, we are going to be hearing from universities. They can speak for themselves. I appreciate your views, but we will also have them up before us.

Mr. O'Neil, what types of exempt organizations are engaging in what you term to be unfair competition? Can you tell me?

Mr. **O'Neil**. Mr. Chairman, I guess in direct contradiction to Mr. Cohen's most recent statement here, I would say universities are probably the single largest source of unfair competition. I cannot speak to the overhead issue he raised.

Chairman **Pickle**. Can you give us some examples of that statement?

Mr. O'NEIL. Oh, in the testing laboratory business, the incidents are legion, Mr. Chairman, hundreds of universities and educational institutions across the country. Travel agents cite universities as a very prevalent type of competitor for their business. Audiovisual and computer stores find universities, whether it is the university bookstore—frequently it is for the computer salesperson—they are frequently sources of competition in the marketplace.

I think Mr. Swain identified the health care area as another particular source of a lot of competition for many of the members of our—he did not use our coalition, but he spoke of small businesses. But in the case of our coalition, the health care industry is one that is the source of a lot of competition also.

Chairman PICKLE. Dr. Hess, you started off by saying you could personally attest to the fact that there was some unfair competition. If I understood you correctly, I think you said with respect to your own businesses. Can you give me some example of how you or your businesses have been affected by this unfair competition?

Mr. HESS. Yes, sir. I can give you as long a list as you would like to have, and I do not know that you want to hear them all here.

Chairman PICKLE. Give us some.

Mr. HESS. I will pick out an example that is very current and very painful presently.

Chairman PICKLE. I beg your pardon?

Mr. HESS. I said I will pick out an example that is very current and very painful. We do a lot of environmental work. We do not do a whole lot of work for the Government, but occasionally we bid on a Government contract for what we call the analytical aspect of Superfund contracting.

It is interesting that you will find in the list of those—companies, I almost said—those institutions that are bidding for Superfund contract which now is nothing more than running a test on a soil sample or water or something like that from cleaning up a waste dump. There is absolutely no research; there is no public information transferred. It is simply gathering that specific information which is strictly commercial and proprietary; that loaded within those groups are what are called CLP labs, are quite a number of universities and nonprofits. And one of the last bids of the University of Iowa was the low bid at the top of the list.

Chairman PICKLE. Do the universities bid on those contracts to do the testing?

Mr. HESS. Yes, sir, they do. It is strictly testing, and it has no research dimension whatsoever.

Chairman PICKLE. And who awards the contract? The Government? EPA?

Mr. HESS. The Government awards the contract based, first of all, on proficiency testing which all of us need to pass in order to be eligible bidders, but then strictly on price.

Chairman PICKLE. And so if a university bids lower, chances are they will get the contract.

Mr. HESS. Right. I have lost a couple of those by being out of the price range because nonprofits were within the price range and the need could be fulfilled.

Chairman PICKLE. So they bid lower because of postal rates and because of other benefits of tax exempt status.

Mr. HESS. It is the whole collection of things which Mr. Motley talked about, and I kind of resent this 50 percent overhead as if they were operating a competitive advantage against us. In reality, equipment that has not been bought with after-tax profits, but rather donated or contributed or gathered from before-tax profits of anything. The fact that, as was mentioned earlier this afternoon, you are dealing with only Federal legislation here, but the granting of 501(c)(3) status triggers a whole series of advantages such as payroll taxes, and Pennsylvania unemployment compensation is not paid by the universities unless it is used. That is more expensive than state corporate income tax.

There is a whole series of things like this that simply make it essentially impossible for the small for-profit business to compete.

Chairman PICKLE. Did I understand you to say earlier that you thought we ought to get more data and information on this before we proceeded?

Mr. HESS. I am saying we ought to get more data and information, yes, but I think there are blatant abuses that need to be corrected presently. The thing that really sticks in my craw more than anything is the absolute fuzziness of the words "substantially related." I think that UBIT is essentially unenforceable with that because those are not quantitative terms.

Chairman PICKLE. The committee may be faced with alternatively saying if you do a specific percentage amount of business then you are going to be taxed. We have that option in the code now, and very few organizations take it. They do not choose that; they would rather have the substantial test. And as interpreted by the Government, the IRS, and by courts, they seem to think that has worked better.

Now, any definition we have is going to be subject to the same interpretation down the street. Let us say that instead of unrelated activity, suppose we said directly related. That is a consideration that has been suggested to us. Even if we did that—and maybe that would be a good point—then down the street they have got to make the same kind of interpretation.

So we cannot just wait indeterminately for data. We have got to try to move forward the best we can. Do you disagree with that?

Mr. HESS. No. I would simply suggest that I am not the tax expert who maybe can write the broad law. But I have thought an awfully lot about our industry and how one would differentiate between what is appropriate and what it not appropriate.

It seems to me that a tax exempt organization has its tax exempt status because it serves some public good or public need. That is the basic test, at least the way I understand it.

Now, if a university professor is engaged in research and he is perfectly willing and able to publish that research in a student's thesis and it is basic and fundamental in nature so that the public can, indeed, get a benefit from that, I would say three cheers, go ahead. But when he is entering into a secrecy contract with a large chemical company, possibly, to do some kind of environmental testing that the results of those tests will be the proprietary and secretive information of the client, I do not think that any of us as taxpayers need to subsidize that thing. I think the client should pay for it, and I think it should be done at a commercial, for-profit, taxpaying laboratory.

Chairman **Pickle**. Do any of the panelists wish to take issue with the statement of another member of the panel for purposes of comparing your viewpoints?

[No response.]

Chairman **Pickle**. Well, that is interesting.

Mr. **Hess**. Mr. Chairman, could I make a comment?

Chairman **Pickle**. Dr. Hess?

Mr. **Hess**. I have talked a good bit about my own specific experience because I can do that in the first person. I simply want to emphasize that as a member of the board of the Chamber and the Small Business Council, and as chairman of the Pennsylvania Delegation to the White House Conference, that the small business is groaning under this burden presently, and the uses of the words "antidotal," "punitive," "machine gun," "meat ax," and that kind of thing is really not helping the situation an awfully lot. I hope that we can be more reasoned in our description of each other's motives and activities.

Chairman **Pickle**. Mr. Motley?

Mr. **Motley**. I would just like to add one other thought, Mr. Chairman; that is, that there is no doubt that there is a great deal lack of data. But there is also no doubt, at least in our minds, that we have members out there, people who have put their life savings into running businesses and trying to create jobs and trying to help the community in their own way, who feel that they are being hurt by competition from certain nonprofit organizations.

I do not think that they can afford to wait until we all have the type of data that we would like to have to proceed and come up with a complete alpha to omega solution to this thing. I do think that the committee has to take a look at it in the short term and to try and possibly come up with some ways to help these people in their situation. They are real live people with real live problems, and they need a real solution from the committee. Thank you.

Chairman **Pickle**. Well, I thank you, Mr. Motley. I know that the panelists are hesitant to give complete information, but I would remind you—particularly you, Mr. Swords—that we put out a press release about these hearings back last fall; September, I think it was, in 1986. It has been a subject of considerable discussion for the past several months. Except for the legislative schedule, we would have already been involved in these hearings.

I ask you what activities are your members actually paying UBIT, and you said you did not know. Now, we have had this subject before us for about 6 months, so I raise the question. As to what specific activities did your tax exempt organizations pay UBIT in 1985 and 1986. I cannot get that from IRS. Only you can tell me, but you tell me you do not know. You do not have any idea.

So while we need more data, Mr. Motley, we are not getting data from a lot of sources we should be getting it from. We must ask organizations that will be testifying in the days ahead to come to these meetings with as much information, and more specifically with examples, of how you, the organization and or your business has been affected or been hurt by it. Making broad statements may give you satisfaction, but we need some factual data here as best we can get it.

I appreciate your own views, and I can recognize that your views are reflected by the organization you represent and they should be. This committee is not trying to start a campaign or conduct a campaign against or toward any one industry, or even groups or types, but rather look at the question as a whole. I want to repeat again that we are trying to find a better answer, if there is one, and to understand better why today we have nearly 1 million tax exempt organizations where just a few years ago we had only a small number.

Mr. COHEN. Mr. Chairman, can I interrupt? Sorry to do this. The data that we have from any time before the mid-1970s is very suspect. When I came before this committee or before Mr. Patman back in the 1960s to give numbers, we were pulling them out of the air because there were no computer records. Many (c)(3) organizations in those days were not required to file. The statute did not affirmatively require a (c)(3) organization to file for exemption. It could wait until somebody questioned its exemption and still apply.

All those rules were changed in 1969, so your data from mid-1970s on is the only hard data. Any data before that is just suspect as all heck.

Chairman PICKLE. Let us take the data from the mid-1970s, then. I have got no objection to taking that as the benchmark. Let us say that.

But the IRS and Treasury said to us that they have over 840,000, even 1.2 billion when you consider churches. So it is obvious that the tax exempts are growing by leaps and bounds, and there has to be a reason for it. Though we have UBIT involved, obviously they are looking for more revenue from some way. We have to try to find an answer. How do we handle that?

Mr. COHEN. The difficulty is you are assuming they all have UBIT. Now, that is an assumption that Mrs. Fremont-Smith and I do not share. Neither one of us, unfortunately, knows whether we are right. That is the problem.

Chairman PICKLE. But you do know what your members, a lot of your members, have done. You know a lot which we do not know unless we get it from the Internal Revenue Service, and that will not be easy, or even appropriate, perhaps.

But, here again, I do not want to single out any one group. It just seems to me like we need the fullest cooperation of all the organizations as we move forward.

I do not think the committee has a specific schedule in mind—that is, a specific proposal—but we do recognize that we have a problem here and we ought to have further clarification. As we move forward in the immediate days ahead, I hope we can get good testimony and that everybody will be as factual and helpful as possible.

I do not have any other questions to ask of the panelists. It has been a long day, but I think it has been helpful. I thank each one of you for your testimony, and we will stand adjourned until Thursday at 9 a.m.

[Whereupon, at 4:31 p.m., the subcommittee was adjourned, to reconvene on Thursday, June 25, 1987, at 9 a.m.]

UNRELATED BUSINESS INCOME TAX

THURSDAY, JUNE 25, 1987

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:07 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

Chairman Pickle. We'll ask the subcommittee to come to order, and ask our guests also to please take a seat.

The Subcommittee on Oversight begins its second day of hearings on a very controversial and timely tax issue, the unrelated business income tax.

Serious questions have been raised about the UBI. Is the tax being administered properly and aggressively? Is the law having its intended effect of preventing tax-exempt organizations from engaging in commercial activities to the detriment of for-profit businesses? Is there compliance with the law? How is the intent of the UBI tax being circumvented through joint ventures, partnerships, or allocations of expenses between nonprofit and for-profit businesses?

We received excellent and comprehensive testimony from the Department of Treasury on Monday, discussing how the UBIT might be improved. Today, I ask each witness to tell this subcommittee what you think of Treasury's suggestions and how any of the suggestions' areas of change might affect you.

Further, I expect each witness, as part of their testimony, to give us specific and factual answers to some of these kinds of questions: for the tax-exempt groups, on what types of income producing activities do you and your member organizations pay UBIT? What is the amount of income that is taxed, and how much tax was paid? What are your major sources of income that are excluded or exempt from the UBI tax and in what amount?

From the for-profit groups, we want to know what specific nonprofit income producing activities has done harm to you and your member organizations through unfair competition? Exactly what is the unfair competition? Which nonprofit organizations are engaging in these activities and to what extent?

It seems to me that these questions need to be answered in full if the subcommittee's oversight review of UBIT is to be complete. Only you, the witnesses, have the information and the answers.

I ask that you summarize your testimony in 3 to 4 minutes and then be as responsive as you can and try to touch on some of the questions we have raised.

I again appeal to you, the witnesses, now and in the days ahead, because there will be three more days of hearing, to give us information that you have, that you and you alone have. We are entitled to that, and if we don't get it from you, then we may have to find other ways to get that information. It would help us if your organization volunteered that information.

Now the Chair first would recognize Mr. Schulze for any opening statement he might make this morning.

Mr. SCHULZE. Thank you, Mr. Chairman.

I am pleased to join you in continuing our hearings on the unrelated business income of tax-exempt organizations.

On Monday, we received the so-called big picture overview of the unrelated business income issue. The Treasury Department had several suggestions to improve the operation of the UBI law. I am sure the subcommittee will give careful attention to their suggestions. I would be interested in the preliminary reaction of our witnesses to the administration's ideas.

The spokesmen for private groups gave divergent testimony regarding the nature and extent of the alleged unfair competition between charities and small businesses. The charities generally denied that there was any unfair competition and said that any statutory changes should come only after new data could be collected. The small business groups painted a picture of increasing unfair competition which they claim has grown beyond the point of minor intrusion.

Today, we will focus on the activities of universities and veterinary groups. Some persons claim that university activities involving research, book selling, and travel services are intruding into the traditional markets of small business. Our witnesses should give us a good comparison of the conflicting claims regarding university activities.

Finally, the witnesses on veterinary medicine should give us a useful comparison of the claims regarding animal care.

Mr. Chairman, I look forward to hearing today's witnesses, and thank you for the hearing.

Chairman PICKLE. Thank you, Mr. Schulze.

Mr. Duncan, do you have any statement?

Mr. DUNCAN. Mr. Chairman, as you know, I'm not a regular member of this subcommittee. I'm an ex-officio member of all the subcommittees.

But I think this is one of the most important subjects that you can hold hearings on this year, and that's the reason I wanted to be here. And I congratulate you on your initiative in arranging the hearings.

Chairman PICKLE. Well, we thank you. We are all glad to have you because you always make an important contribution.

Now, our first witness this morning will be a former Governor of North Carolina, and now U.S. Senator, the Honorable Terry Sanford..

Senator, we are particularly pleased to have you this morning, and thank you for coming over and sharing your time with us.

The Chair is pleased to recognize you for your statement.

STATEMENT OF HON. TERRY SANFORD, A U.S. SENATOR FROM THE STATE OF NORTH CAROLINA

Senator SANFORD. Well, Mr. Chairman and members of the Oversight Subcommittee, I thank you for this opportunity to come and talk about universities and the businesses in which they are engaged. As you are probably aware, I spent 16 years as president of Duke University, and I would like to focus in my remarks on the vital contributions that universities make to their communities, their States, and to our Nation. Certainly the role of colleges and universities within our society extends far beyond just providing a quality education for young adults, as important as that is. It is for this reason that I am so interested in your investigation into the tax treatment of college and university activities, such as research and fiscal management and the sale of essential education-related goods. I doubt seriously that universities compete very much with private business. Primarily, universities are concerned with the educational function, the research function and doing those things that are related to carrying out their important mission for society. No universities or colleges that I know anything about are making any profits. All of them are doing well just to keep their budgets in balance.

Colleges and universities have traditionally provided many of the facilities and the staff and much of the academic impetus to the conduct of basic research. As a matter of history, most of the basic research undertaken in this country has been done in campus laboratories. College and university research ranges from developing beneficial soil treatment at North Carolina State University to perfecting plasma physics applications at Princeton University. The entire spectrum of society benefits from research that takes place in our colleges and universities. The thrust of our technological advancement has largely emanated from universities.

While tremendous complications are involved in legislation regarding university activities and the tax status they are accorded, I believe that adequate provisions already exist to distinguish between basic or applied research and research undertaken solely for commercial purposes. The statutory and regulatory treatment of research is straightforward. Revenues derived from research are not taxable if the research is substantially related to the exempt purposes of the organization conducting the research. Three specific categories of research are exempt from any unrelated business income tax. First, research for governmental agencies; second, research by a college or university; and, third, research by a basic research institute if the results are made publicly available.

To attempt to legislate still finer distinctions between these types of research enterprises, such as by demanding that they define the end uses of their research endeavors before such endeavors get underway is unattainable, and is probably an undesirable goal. In fact, it is the unlimited possibilities of where research might lead that truly has been the way we have made technological advances in this country.

The exemption for university research ensures that all university research, both basic and applied, is protected. Despite our leadership in scientific theory, the United States has lagged behind other nations in applied research, which bridges the gap between basic research and commercial utilization of those scientific advances. Colleges and universities must be an integral part of any national effort to promote applied research. We must not, I suggest, enact laws that discourage applied research, either by taxing it directly or by blurring the current line between applied research and research undertaken for commercial application. Because commercial or industrial research is not tax-exempt, colleges and universities are encouraged under current law to transfer new technology to private enterprises at the point where it becomes commercially viable. This practice of taxing commercial research, while leaving vital applied research in the tax-exempt category, has served well both our colleges and universities and the whole business community.

In addition, I am all too keenly aware of the importance of an endowment to a college or university and of the difficulty in building and maintaining one. An endowment is an institution's safety net in that it permits the institution to withstand short-term financial or political pressures.

It is also the source of the independence of universities which has been extremely important in our society. During my years at Duke, our endowment resources helped at times to compensate for cutbacks in Federal student aid, enabling us to fulfill our commitment to educating promising students whose personal or family financial resources might otherwise have precluded their attending college.

Continuing Federal cutbacks have made endowment resources even more critical and thus, colleges and universities are now devoting more care and attention to managing and maximizing the income from these assets. It is important that this investment income not be burdened by Federal taxes. Universities are not managing their financial resources to avoid taxation, nor does this financial management create competition with private enterprises. In planning for their financial well-being, colleges and universities are merely acting prudently today to ensure that quality education remains available and affordable in the future.

I would like finally to discuss briefly the services that colleges and universities provide to their own students and faculty. The specific exemption for activities carried on for the "convenience" of students and faculty permits colleges and universities to provide housing, food service, supplies, and basic goods to the college community. The availability of these basic services is particularly necessary on rural campuses where commercial establishments may not be readily accessible. While I do not support having colleges and universities involved in businesses which have no relation to their curriculums or to daily campus life, I also do not believe continuing to afford tax-exempt status for books, school supplies, clothes, campus lodging and dining facilities would necessarily have a detrimental effect on the ability of small businesses to compete.

Many colleges and universities already have begun voluntarily to restrict access to auxiliary services on their campuses to students and faculty, or to limit the extent of such activities to the amount necessary to serve the needs of the campus community. For example, when some institutions agreed to sell computers to students and faculty in order to pass on sizable manufacturer discounts unavailable through private vendors, they declined to furnish software, peripherals, or upgrades, thereby actually increasing business for local vendors.

The abuses of which small businesses have complained have been, in my view, isolated instances capable of being dealt with by specific rules or regulations of IRS. These few cases should not be allowed to become the basis for fundamental changes in the way colleges and universities are treated for unrelated business income tax purpose.

I am only too aware of the important role colleges and universities in stimulating not only intellectual advances, but also economic growth. As you undertake this important review of the tax laws affecting these institutions, I ask that you proceed cautiously to ensure that the vital balance between colleges and universities and their communities is not disrupted. For example, curtailing the applied research efforts of colleges and universities in developing technologies which can be readily exploited by private businesses would create a gap between basic scientific advances and their productive commercial use. I know that without university participation through applied research, private sector businesses often will not have or expend the resources necessary to initiate and pursue these complex and uncertain endeavors. We cannot afford to risk our technological future on the accidents of the marketplace.

In closing, I want to express my appreciation once again to the chairman and the members of this subcommittee for affording me the opportunity to appear before you this morning. I have only the utmost respect for your having undertaken to study this complex issue, and I know that you will bring to your task both sensitivity and insight.

It is important, I think, that none of us becomes lulled into thinking like those who want to put a price on everything but who have no sense of the value of anything. There are benefits that accrue to our society from colleges and universities on which we cannot easily place a price tag and for which, therefore, we will never be able to assess a fair tax. We must hedge against the temptation to try to find simple answers to complex problems, or to create new legislative devices to deal with problems that are far better addressed through rulemaking and regulatory change rather than through sweeping statutory reform.

Colleges and universities have, throughout the history of the Nation, contributed so much in so many ways, and it is my opinion that they have done very well in keeping their financial houses in order, and that they haven't done any substantial damage, if any at all, to private business. In fact, I doubt seriously that there is a college town where private enterprise hasn't benefited and indeed profited from the presence of that institution.

I thank you so very much.

Chairman Pickle. Senator, we thank you for your statement and for your personal appearance here this morning. I am sure all of the members of the committee are very cognizant of the importance of basic research carried on by the University of North Carolina or Pennsylvania or even Arkansas.

Where you draw the line, on the exemption from UBIT for applied research that might or might not enter into the marketplace, is a line we have been asked to examine by the chairman of our committee and by the administration. It is a difficult question to try to solve, but we will proceed cautiously. I also think and hope that the committee will proceed in a way that can better define what is a for-profit and what is a nonprofit organization so that we all can have a better understanding of the UBIT. Coming from the University of Texas, I know how important it is.

Also we are part of the overall problem. We have got to find out just where we do fit into this nitch.

Mr. Schulze, do you have any questions of the Senator?

Mr. SCHULZE. Just one very briefly, Mr. Chairman.

Thank you, Senator.

In your testimony you state that the abuses about which small business have complained are capable of being dealt with by specific rules or regulations. I presume you don't have those with you, your specific recommendations, but it would be very helpful to the committee if you would send us a list of those specific recommendations.

Senator SANFORD. Well, I think that the IRS has been reasonably good in working out what is business related and what is not. We worked out with IRS at Duke University, for example, about what part of our management of some 4,000 acres of forest was related to the educational process and what was related to commercial uses.

Now, we could give you a great many examples of that kind, but I think you could get a clearer idea of how IRS works in solving these problems by consulting the legal department of any major university.

For example, I know of a situation in a nearby school where, on bad legal advice, they built a shopping center and, of course, the IRS ruled they had to pay taxes. I think they ultimately disposed of the property.

So, I haven't really seen any continuing abuse. At Chapel Hill for a long time, the book exchange, which was in the center of the campus, was the object of concern of one State legislator from that county because the downtown stores, who survived and profited from the presence of the university, nevertheless didn't want the students having the convenience of a book store in the center of the campus. And so the North Carolina Legislature enacted the Umsted Law that prohibited people that weren't connected with the university from purchasing there.

Mr. SCHULZE. Senator, do you think that's a good way to go to have that as you described it, and did that work out well?

Senator SANFORD. Oh, I think it's worked virtually everywhere, and I don't know what IRS would say about it. But certainly those at North Carolina that I have been associated with feel that we have always come to very fair conclusions.

It is so hard to define things statutorily. We can't even define applied research in the academic world. Where does it begin and where does it stop?

In my experience, research overall is a losing process if you look at it commercially. It almost has to be. Who is going to start out looking for a truth or looking at a problem without any commercial value? Only the Federal Government in supporting research and universities can pursue that kind of research. Yet, almost all of our great advances and breakthroughs have come from that kind of pure research. We are not having to look at the quarterly report of profits. And I don't want to do anything to damage it.

Mr. **Schulze**. Senator, as decisions were made, was this a part of the decisionmaking process, whether it was related or unrelated? You talked about the bookstore and the forest trees——

Senator **Sanford**. Well, yes, we wanted to start, for example, a travel agency, because we were having so much trouble with some departments, and the medical center was also having a number of serious travel-related problems of its own. And we examined the situation very carefully. And I declared from the very beginning that it would be an unrelated business and it would be taxable.

I think most universities would do that because there is IRS watching.

Mr. **Schulze**. Very good. Thank you, Senator.

Thank you, Mr. Chairman.

Chairman **Pickle**. Any other members have questions?

Mr. Thomas.

Mr. **Thomas**. In terms of research, based upon your experience as president of Duke University, can you give me some idea of the trend? I know research basic and otherwise is driven by brain power, and that's one of the reasons we utilize our universities. But also to a great extent, it's technological today, and there are greater and greater requirements for not just specific but very sensitive and very expensive equipment.

Are we seeing a continuing trend of research grants providing particular equipment to universities to utilize?

Senator **Sanford**. Well, thank you for making that point because, obviously, we have let the instrumentation of research run down. And that's a danger for the future competitiveness of this Nation, not only because we don't have the research facilities for our senior faculty and researchers, but we don't have it for the training and the instruction at the student level. It's been one of the great neglects, and it's been difficult sometimes for policymakers to understand that equipment needs to be not leftover equipment, but the equipment at the university level needs to be on the cutting edge. And that's the way we advance technology in our post-industrial society.

Thank you.

Mr. **Thomas**. Well, my concern is that at one time you had brain power and you had the equipment when all you needed were test tubes and Bunsen burners.

To the degree that research grants also provide the sensitive instruments necessary to carry on the research, I think we have to rethink just what is a research grant and the way in which that grant, along with equipment, is applied and utilized at universities because, ultimately, you walk away from it. On the research, you've got a teaching instrument that has advanced from the previous one, and I think that has to be considered as well.

Thank you very much.

Senator **Sanford**. Thank you.

Mr. **Anthony**. Mr. Chairman.

Chairman **Pickle**. Mr. Anthony.

Mr. **Anthony**. I have just one question.

Coming from a smaller State and having spent several hours of looking through the records to determine where research grants go, one finds that there seems to be a bias as to where the research money actually goes.

Senator, how would you go about addressing that imbalance?

Senator **Sanford**. Well, we can't go about it, as I'm often tempted to do, by simply putting in a bill and giving a research grant to some university. We have to use a peer review approach. And there's not any question that peer review sometimes gets biased in favor of the peers; that the peers are not selected broadly enough.

I think we need to look, and this is slightly off the point of the subject of this hearing, but I think we need to look at the research effort of the Federal Government. I think it's scattered now. It's fragmented. It's difficult to get the National Science Foundation cooperating with the National Institutes of Health partially, and maybe primarily, because of the incoherent statutory framwork in which they operate.

I would like to see us get some of the funds out of the Energy Department, some of the research funds out of the Defense Department, and have the National Science Foundation cultivated more as an umbrella organization, distributing funds to universities to encourage those universities to develop stronger research facilities. We have had too narrow a view of what a research university is, and I quite agree that we need to broaden it.

Mr. **Anthony**. I think what bothers me is that you've got your exempt categories, but if the research is successful, then you have the potential for business income related ventures as a spinoff from it.

So there appears to be the possibility that some universities could be hurt if we don't take a broad view of some of the problems.

I think your testimony has been very forceful, and coming from a background of experience. I hope we get the same straightforward testimony from other witnesses.

Senator **Sanford**. Thank you.

Chairman **Pickle**. Thank you, Senator.

Senator **Sanford**. Thank you very much.

Chairman **Pickle**. Now the Chair will ask the first panel to come forward. That panel consists of Dr. John DiBaggio, Mr. Steven Altman, Mary Jane Calais, Dr. Robert J. Bruce, and Jeff Carr.

If each of you individuals will come to the witness table.

Let me make this observation for our committee and for the witnesses today. We have scheduled today six panels. Each panel has approximately four to six witnesses in a panel. Therefore we must make use of our time. We are going to ask the witnesses to attempt to summarize their statement in three or four minutes, and that will enable us to ask any questions we might care. But we want to get the information on the record, and we are asking you for your cooperation.

Let me have these people identified. First, Dr. John DiBiaggio, president of Michigan State University, and representing—these are all nonprofit university witnesses now. Steven Altman, president of Texas A&I. The National Association of College and University Business Officers represented by Mary Jane Calais.

Mr. MASON. Mr. Chairman.

Chairman PICKLE. Yes.

Mr. MASON. My name is Thomas Mason. I'm vice president for Business Affairs at the University of Notre Dame, and I will be representing the National Association of Colleges and Universities.

Chairman PICKLE. Your name is Thomas——

Mr. MASON. Mason, M-a-s-o-n.

Chairman PICKLE. All right. And then Dr. Robert J. Bruce, president of Widener University, and Jeff Carr, vice chancellor for the university relations and general counsel, of Vanderbilt University.

Mr. SCHULZE. Mr. Chairman, if I may welcome Dr. Bruce, who is a constituent. Widener is a constituent college in my district. We are pleased to have you here, doctor.

Dr. BRUCE. Thank you.

Mr. SCHULZE. He's very active in community affairs, a good citizen, and the university is healthy and makes great contributions to our community.

Chairman PICKLE. We are glad to know that relationship, Mr. Schulze, and we welcome you, Dr. Bruce.

Now I am going to ask Dr. John DiBiaggio to proceed with your testimony.

STATEMENT OF JOHN DiBIAGGIO, PH.D., PRESIDENT, MICHIGAN STATE UNIVERSITY, AND CHAIRMAN, NATIONAL ASSOCIATION OF STATE UNIVERSITIES AND LAND-GRANT COLLEGES, ON BEHALF OF THE AMERICAN COUNCIL ON EDUCATION (AND 18 OTHER HIGHER EDUCATION ASSOCIATIONS)

Mr. DIBIAGGIO. Thank you, Mr. Chairman.

I am John DiBiaggio. I am president of Michigan State University, and chairman of the National Association of State Universities and Land-Grant Colleges. I am testifying today on behalf of 18 higher education associations that are listed on the cover sheet of the statement that was filed by the American Council on Education.

As you can all appreciate, that in itself is a pretty impressive matter, 18 associations with differing views, coming together in unanimity on an issue of this grave consequence.

We do commend you, Mr. Chairman, for holding these hearings. This is indeed an important issue, an issue that must be addressed very carefully, and one in which we want to be fully cooperative. And we do want to respond to any of the questions that you might have.

I know that I needn't explain to you the importance of American colleges and universities to the competitiveness of this Nation. You have supported very generously in the past research and development tax incentives, Mr. Chairman, which have been enormously helpful to our institutions. And for that, we are extraordinarily appreciative.

The functions of higher education are very broad and complex indeed. Certainly my institution, which enrolls some 42,000 students, is an example of that complexity from its research to its education to its service efforts. Thus, the laws that regulate those functions must themselves be both complex and, I would contend, very flexible.

The tax law now exists affects colleges and universities in important ways. And I think it does reflect many decades of experience and decisions and instances in which different objectives have been weighed, and competing considerations have been carefully balanced.

We believe quite firmly that the basic related standard of the unrelated business income tax is singularly suited to the purpose. It allows colleges and universities to pursue their threefold mission of teaching, research, and public service, without undue burden. And it taxes the conduct of activities not consistent with such purposes, as it appropriately should do.

Similarly, we believe that the statutory exemptions to the tax that affect colleges and universities should be carefully preserved. Those statutory exclusions, specifically the exclusions for income from basic support services, for passive income, and for research and royalty income, reflect congressional judgments concerning the social significance of the exempted activity, and a desirability of encouraging such activity.

Mr. Chairman, rather than read from a prepared text, let me say to you that the current law does indeed work, if applied. We are an institution that has always carefully, and dutifully submitted its 990T forms.

We have been audited by the Federal Government, and in that audit certain items have been challenged, and we have gone along with the conclusions of IRS.

For instance, they have suggested that certain items, indeed, are taxable income, that we derive at our institution, including our computer center. Our academic computer center sells some of its time to certain commercial entities in the mid-Michigan area.

To the extent that the sale of that time represents a direct sale, and is not part of our sponsor research programs, the university incurs taxable income. At our university golf course, which is an interesting one, and our tennis facility, we admit alumni and members of the general public, in addition to our students and staff, to those facilities. The IRS position is that the sale of those services to alumni and the general public is taxable, and we think that is entirely appropriate as well.

Our alumni association. You have heard about that, to some degree, in terms of tours and tour programs which are not specifically educationally related—should, of course, be taxable, and we agree with that conclusion.

We had another instance at our institution where we sell group life insurance through our alumni association. There were some profits from those sales. Those were taxable. We of course agreed with that.

So, in each instance, when a law has been applied appropriately, our institutions have responded and have agreed that there are certain kinds of income that, indeed, should be taxable, and the taxes should be assessed against us.

I might add, parenthetically, they excluded many items that we reported in which we showed significant loss, and, indeed, that did put us in a position where we were taxed, if you will, for those things in which we, in essence, showed a profit.

Well, because of the practical demands of the educational function and the educational institutions have historically furnished, and educational support services for the convenience of our students, et cetera, we think that the code, as it is now written, does provide for certain exceptions which are very, very important, indeed.

Now as I understand it, Mr. Chairman—and please correct me—I am testifying for more than one association, so I have a bit more than the four minutes that are normally allocated to a witness. Am I correct? I notice the lights flashing in front of me already, and I want to make certain of that.

Chairman PICKLE. Well, Dr. DiBiaggio, I am going to suggest that you conclude your statement at this point. We will go to the other members, and then we will be willing to come back to yield you additional time. I know you represent the broad group of the American Council on Education, and you have given us a statement here that is about the size of the New Testament, and maybe as good, in some instances, we will say. But we will examine those, and we will try to yield you more time later.

Do you want to make an additional conclusion before we recognize anybody else?

Mr. DIBIAGGIO. Well, sir, let me just simply say that we recognize that there are issues of unfair competition that need to be addressed, and we believe that debate on these issues must also take into account broader national concerns.

To the extent that colleges and universities carry on activities that do not promote their tax-exempt purposes, we think there is broad consensus within our institutions, that the income tax from such activities should be subject to tax.

Based on our current knowledge and experience, however, we believe that the unrelated business income tax, as it is presently structured, properly applied and administered, adequately provides for this.

Thank you, Mr. Chairman.

[The statement of Mr. DiBiaggio follows:]

STATEMENT OF THE

AMERICAN COUNCIL ON EDUCATION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON BEHALF OF:

American Association of Community and Junior Colleges
American Association of State Colleges and Universities
American Association of University Professors
Association of American Medical Colleges
Association of American Universities
Association of Catholic Colleges and Universities
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Association of Urban Universities
Council for Advancement and Support of Education
Council of Independent Colleges
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of State Universities and Land-Grant Colleges
National Association of Schools and Colleges of the United Methodist Church

On behalf of the American Council on Education, an organization representing over 1,500 colleges, universities and organizations in higher education, and the associations listed on the cover sheet of this testimony, we are pleased to present our views on the application of the unrelated business income tax provisions of the Internal Revenue Code to colleges and universities.

The tax law as it now affects colleges and universities reflects many decades of experience, many decisions, and many instances in which different objectives have been weighed and competing considerations have been balanced. As complex as it is, however, the tax law is only one part of the web of federal and state legislative and administrative actions that together reflect our society's expectations of higher education. Over more than two centuries, colleges and universities have grown from simple academies to remarkably complex institutions, largely in response to public mandates reflected in this variety of laws. As the requirements of our nation have changed, and as limitations on the capacity of other institutions to meet these requirements have become apparent, the leadership of this country has called upon colleges and universities to assume additional functions and responsibilities. All of us feel considerable pride in the way our colleges and universities have expanded their reach in response to these challenges.

In dealing with educational institutions that have been undergoing almost constant change and growth, the tax law -- both in its structure and in its administration -- has been flexible and sensible. The unrelated business income tax in particular reflects the care with which government has traditionally approached issues affecting higher education. Recognizing this, the higher education community regards as significant and serious any Congressional inquiry such as this one.

The issues noted in the press release announcing plans for this hearing were very broad, and some were very basic. This Committee will be considering questions that cannot be understood out of context, and that certainly should not be addressed from any limited or short-term perspective.

It may be useful to keep in mind that prior to enactment of the unrelated business income tax in 1950, exempt organizations were virtually unregulated as to the nature or the sources of their income. The unrelated business income tax imposed very substantial limitations on the ability of such organizations to finance their charitable or educational activities through the conduct of unrelated profit-making ventures. The structure of this tax reflects the intent of the Congress to promote fairness by taxing activities that do not further exempt purposes, while leaving exempt organizations free to pursue their charitable or educational missions without the burden of taxation.

That policy was sound in 1950, and we have seen nothing to suggest that it is less so today. Accordingly, we believe that the basic "relatedness" standard of the unrelated business income tax, which reflects the purpose and which accomplishes the objectives of the tax, should be maintained. Similarly, we believe that those statutory exceptions to the tax which reflect social policies of current significance should be preserved. If there are abuses, or problems in the administration of the tax, our institutions will support efforts to correct them. There is too much at stake, however, to abandon a basically successful structure.

This society now looks to higher education, perhaps more than at any juncture in our history, to meet a variety of intellectual, cultural, social, economic and technological needs. The unrelated business income tax has traditionally been responsive to those needs. I trust that it will continue to be so.

Functions of Higher Education

One of the questions before this Committee is the effectiveness of the unrelated business income tax in focusing upon activities that are not related to the charitable, educational, or scientific purposes of organizations otherwise exempt from tax. This relatedness standard assumes an understanding of the exempt purposes of various tax-exempt entities.

In some cases, the exempt purpose of an organization may be self-evident. In the case of colleges and universities, however, exempt purposes may seem easier to define than they actually are. An over-simplified view of the exempt functions of higher education may cause confusion as to the appropriate application of the unrelated business income tax. For that reason, it may be useful to examine how colleges and universities pursue their traditional functions of teaching, research and public service.

(i) Teaching and Educational Support Services

Teaching is the most obvious of the functions of our colleges and universities. Higher education provides individuals with an understanding of our cultural and intellectual heritage, as well as the skills to pursue careers and economic goals. Institutions of higher education have sustained this mission for over 350 years. They have preserved the legacies of our past through a succession of cultural fads, political changes, and ideological movements.

In many other countries, higher education is provided and paid for by the national government. In the United States, this burden is largely assumed by state and local government institutions and by private non-profit colleges and universities. The spectrum of American higher education includes major public and independent research universities unmatched anywhere in the world; an extensive network of state colleges; a wide range of liberal arts colleges, many of them with church affiliations; and a system of community colleges that now provide access to higher education for millions of Americans. Each of these institutions acquires an identity, directs its resources, and develops particular academic strengths, typically in response to the needs and interests of the community or constituency it serves. This decentralization contributes to the depth of our higher education system.

The teaching of individuals is the core of higher education, the function which is indisputably appropriate for colleges and universities to pursue. This function cannot, however, be carried out in a vacuum. Students must be housed and fed, books and supplies must be made available, visiting faculty and parents must be accommodated, basic needs must be met. Because of the practical demands of the college and university community, educational institutions have historically furnished educational support services for the convenience of their students, faculty and staff.

It is important to understand that colleges and universities began to operate facilities such as bookstores, dormitories and cafeterias because necessary services were not available on a reliable long-term basis from the profit-making sector. Campus facilities maintained by colleges and universities are responsive not to profit calculations but to the needs of the campus community. The college or university makes decisions about the products and services it will provide on the basis of educational objectives, and these decisions typically reflect the involvement and the concerns of the faculty.

If colleges and universities were to withdraw from the operation of educational support services, some would not be provided at all, and others would be operated under the constraints and criteria characteristic of for-profit ventures. We believe that would be an unfortunate change. Campus services that are self-supporting this year may not be so next year or ten years from now. Businesses cannot be expected to maintain a commitment to deficit operations. At the same time educational institutions cannot be expected to withdraw from educational support operations during particular periods, and yet maintain the staff, assets and capacity to move back in when the economics of the operation shift. Even in a given period there are particular services or products within any one of the traditional campus enterprises that are more or less economical. The college or university can in all of these instances take campus rather than commercial considerations into account.

(ii) Research

Just as the growth of a humane and skilled society depends upon the teaching offered by its colleges and universities, so the advancement of new knowledge and its transmission to future generations, the development of technology, and the creation of a climate of innovation all depend upon the sustained conduct of fundamental research. Historically, universities have been at the center of this kind of research effort.

Universities have demonstrated a commitment to research because, in and of itself, it advances the frontiers of knowledge in many fields. Our best and brightest scientists are attracted to teaching and research careers precisely because universities allow research to be pursued in a systematic and sustained way without reference to short-term market considerations. Advanced education and training is enhanced when it is provided in conjunction with research, so that students can work along with scientists and faculty in the pursuit of new knowledge.

Since World War II, the federal government has looked to our universities as the setting for the conduct of a broad range of needed research. With the acceleration of technological developments on an international scale, it had become apparent that a gap existed between the research achievements coming out of universities and the translation of those achievements into product development by the business sector. Faced with increasing concern as to our technological status, the government recognized that this gap or middle ground -- which can be called applied research -- was not reliably occupied. Like basic research, applied research must be conducted on a long-term basis, and thus requires a long-term commitment, independent of market fluctuations or the demands of immediate productivity. It is a commitment that is very difficult for business to make, and yet the development of new and successful products requires that businesses have access to the results of this kind of research.

The concern about this gap in our national research and development capacity led the federal government to look to the university community as the obvious and indeed the only likely source of a more concerted applied research effort. It became clear that universities were at least potentially in a position to make significant contributions to the business sector through the transfer of technology. Universities thus became the focal points of federal funding of applied research, serving as the primary link between federal support of research and the commercial exploitation of technology by for-profit enterprises.

The tax law recognized the need for this commitment to both basic and applied research by specifically providing that the research activities of colleges and universities are not subject to the unrelated business income tax. This statutory exclusion for university research does not apply to activities of the type ordinarily carried on as an incident to commercial or industrial operations. Thus, present law essentially distinguishes scientific research from commercial product development activities. It draws the line in a way that generally matches the realities of our economic world. Universities are encouraged to participate in the research process at the stages -- specifically basic and applied research -- where the development and application of new knowledge is paramount. The result of that research is then turned over to the business world at the stage -- specifically product development -- when the marketplace can provide sufficient motivation for commercial activities.

Drawing the line between the scientific research properly and necessarily conducted by universities and the commercial product development properly undertaken by the business community may not always be simple. Indeed, it would be surprising if the line could be drawn in such a way as to avoid absolutely any overlap between university research and commercial activity. Generally, however, the business community cannot invest in basic and applied research to an extent that is anything close to that necessary to satisfy our national objectives. That is why most research-intensive companies in the United States are interested in encouraging rather than discouraging university scientific research. They see it as essentially complementary to, not competitive with, their own companies' activities.

The recognition of a broad range of research activities as consistent with the exempt functions of our universities is critical to our chances of recapturing our competitive position in the world economy. Continuing involvement by our universities in research is necessary to support the expansion of knowledge, to provide scientific and technological training, and to promote the technology transfers on which our economy depends.

As you know, the interaction of university and business research has been the subject of Congressional consideration in contexts other than this one. The Uniform Federal Patent Policy Act, for example, allows universities to claim ownership rights to patents developed as a result of federal funding of research. This law reflects a Congressional understanding that appropriate incentives are needed to ensure that university research discoveries are transferred to the for-profit sector for product development. Prior to enactment of the Uniform Federal Patent Policy Act, some 23,000 otherwise patentable discoveries made with federal funding were placed in the public domain and then lay fallow, without the investment available for development, because without rights to exclusive use of the discovery there could be no adequate incentive for profit-motivated investors. Thus, the Congress recognized that in the area of technology transfer, the promotion of broad social interests required the protection of particular financial interests, including the interests of the universities.

There are many other examples of the federal policy of promoting university-industry cooperation, including Federal income tax provisions. The Economic Recovery Tax Act of 1981, for example, expanded the incentives for cooperative efforts by providing generous deductions for contributions of scientific equipment to colleges and universities and by allowing a tax credit for expenditures in connection with university basic research. By enacting measures such as these to promote university research and to facilitate the transfer of technology from universities to industry, Congress was not trying to favor universities over business. It was trying to encourage research activity that was not otherwise being conducted, or that was not otherwise finding its way to the marketplace. It would be sadly ironic to hamper here the precise efforts which Congress has elsewhere attempted to stimulate.

(iii) Public Service

Colleges and universities, and particularly our land-grant institutions and other institutions supported by state and local governments, have a history of public service that extends back to the earliest days of higher education in this country. The landmark federal education bills of the nineteenth century, state legislation, and the state charters of public universities, all contain unequivocal mandates to these institutions to provide practical assistance to their communities. The Hatch Act of 1887, for example, directed that funds be provided to establish agricultural experiment stations at land-grant campuses, "to promote scientific investigation and experiment respecting the principles and applications of agricultural science". The Smith-Lever Act of 1914, which established agricultural extension programs in the states, directed colleges and universities to bring the practical results of agricultural research directly to the farmers.

Pursuant to these legislative mandates, and consistent with their own long traditions, colleges and universities provide public services that range from continuing education and adult education programs to technical assistance to low-income health clinics. In many rural areas, the college or university is the center of the community in both a social and an economic sense. Virtually every citizen in such a community is a beneficiary of the public service and educational programs of the college or university. In many cases, the campus is a source of critical support to small farmers and small businesses.

State universities and land-grant colleges are hosts to most of the Small Business Development Centers sponsored by the Small Business Administration. The centers provide economic analysis and counsel, information specialists and counselling services, and laboratory and adaptive engineering facilities to small businesses. State-funded agricultural and economic assistance programs are often attached to state educational institutions. Such programs rely on the resources and facilities of the educational institutions in assisting local farmers and businesses.

In addition to the federal and state support channelled through higher education, state colleges and universities themselves provide consulting and other support services that allow businesses to participate in the growth of the local economies. The Texas Engineering Service, the Georgia Institute of Technology's Industrial Extension Division, and Pennsylvania's PENNTAP Technical Assistance Program, for example, each offer help to small local firms. Modelled on the more traditional agricultural extension programs, these "technological extension" programs provide assistance to companies that cannot afford in-house expertise. The University of Wisconsin has created small business development centers at eleven campuses of its statewide system, and operates thirteen business outreach programs through its UW-Extension. Wisconsin's University-Industry Research Program provides help in a variety of forms to local enterprise, from economic growth planning seminars for small towns to venture fairs where selected entrepreneurs present their business plans to potential investors.

Often particular services provided to the community by a college or university are part of a broader or longer-term teaching or public service function. For example, free health care services offered to low-income members of the community, such as pre-natal and post-partum care programs or vaccination programs, are often part of the education of medical students. Similarly, soil testing services have traditionally been offered by state educational institutions to local farmers in conjunction with efforts to monitor the fertility of soil in various locales over long periods. Soil samples are used in connection with teaching, and are also used in faculty studies and projects to develop changes in testing procedures over time. Soil test data are used in connection with agricultural extension services provided to local farmers, and can be used in the counselling and economic analysis services funded by the federal and state governments. Finally, data from soil tests are often published, and are used in many environmental research studies funded by the institutions.

It is evident that, pursuant to their charters and to long tradition, colleges and universities support and serve their communities in ways that are integrally related to their teaching and research functions. The relationships between colleges and universities and their communities are, particularly in rural sections of the country, basic to daily cultural and economic life.

Structure of the Unrelated Business Income Tax

As noted above, the functions of higher education are broad and complex, and have expanded over time in response to changing national needs and to specific state and federal mandates. Thus, laws which regulate these functions must themselves be both complex and flexible. Such laws must be responsive to the intellectual, social and economic needs that are served by colleges and universities, as well as the complementary or conflicting needs of other sectors of our society.

We believe that the unrelated business income tax has done this reasonably well. The statutory structure of the tax seems to be responsive to the objectives that the tax is intended to serve. Before we try to evaluate possible problems with the tax, therefore, we should focus upon what we believe to be its essential soundness.

In deciding whether income from a particular activity is subject to the unrelated business income tax, three determinations must be made: first, whether the activity constitutes a trade or business; second, whether the activity is "related" to the exempt purpose of the organization; and third, whether the income from an unrelated business activity falls into one of the categories of income that are excluded by statute from the taxable base.

The "relatedness" standard, we believe, is singularly suited to do what the Congress intended the unrelated business income tax to do. It allows exempt organizations to pursue their charitable or educational purposes without undue burden, and it taxes the conduct of activities not consistent with such purposes. The standard allows for some flexibility in recognizing that the functions of charitable or educational organizations may evolve and develop over time, and that even at any one time the functions of institutions such as colleges and universities may be quite diverse.

We believe that something like a relatedness standard is inherent in any tax that might be imposed on charitable and educational organizations. No one has yet been able to suggest any kind of objective standard, any kind of bright-line test, that does not involve what seem to be very significant social costs. Any departure from the basic relatedness standard would almost certainly restrain and burden activities otherwise recognized as important to our national well-being. We believe that it is far preferable to devote greater resources to the administration of the present relatedness standard than to allow some artificial and inflexible legal standard to influence the functions of important social institutions.

Once the relatedness standard has been applied, it must be determined whether income, although derived from an activity not directly related to the furtherance of exempt purposes, is nonetheless excluded from the taxable base. These statutory exclusions reflect Congressional judgments concerning the social significance of various kinds of activity, and the desirability of encouraging such activity. In that connection, we would like to focus briefly upon three areas of particular concern to higher education.

The first is the exclusion from the definition of unrelated business taxable income of various forms of investment income and investment return: dividends, interest, capital gains, rents from real property. This exclusion allows colleges and universities to build and maintain endowments without the burden of taxation. An endowment fund is the capital of the institution, formed through gifts of cash, securities, and other properties by individuals, businesses and foundations. Many of these gifts are restricted by the donors for use in specific programs such as scholarship funds. Colleges and universities use income earned by their endowments to cover part of their operating expenses, with a portion of the income typically reinvested in an attempt to see that long-term endowment growth can keep up with inflation.

An endowment, even of moderate proportions, provides a college or university with a buffer against short-term swings in the economy, in the student population, or in popular opinion. It gives the institution some ability to cope with immediate financial pressures on admissions, curriculum, and faculty hiring. Based on their endowment income, for example, colleges and universities have been able to help fill part of the gap left in student assistance programs by cutbacks in Federal student aid. Some universities have relied on endowment income to support an admissions program under which students can be accepted without reference to family financial capacity. Many rely on endowment income to attract and retain scholars, teachers, and researchers.

For 1985, 284 colleges and universities reported having an endowment exceeding $1 million; 164 institutions had endowments of over $25 million; and 66 reported endowment amounts in excess of $100 million. Although we have seen recent growth both in the number of institutions with endowment funds and in the size of the average fund, however, the 1985 Endowment Performance Study conducted by the National Association of College and University Business Officers indicates that in real terms, taking inflation into account, endowment funds in general have actually declined in purchasing power since 1973 by some 4.11 percent, based on the Consumer Price Index. Thus, for most colleges and universities, endowment income is able to cover a decreasing proportion of basic operating expenses, and can contribute less to scholarship programs and programs to meet special student needs.

With our widely shared worries about increasing educational costs and with restrictions on the Federal funding of student aid and other education programs, any such decline in the role of endowment funds must be a cause for concern. We should not compound the unavoidable problems of inflation and economic uncertainty by imposing tax costs on colleges and universities which attempt to meet some of their income needs through investment of their endowment. The investment-oriented exceptions to the unrelated business income tax were intended to free endowment income from such tax burdens. These rules are a logical extension of the longstanding tax policy that charitable and educational organizations are not taxed on gifts and contributions. The decision to enact those rules was sound in 1950. Their preservation is essential today.

Our second concern involves the royalty and university research exclusions, which universities rely upon in their programs of applied research and technology transfer. In a real sense, of course, all of the basic and applied research conducted by universities is related to the universities' exempt function, so long as the research is not incident to commercial or industrial operations. The statutory exclusion for university research, and the royalty exclusion to the extent that it is involved in technology transfers, serve to emphasize and confirm that the entire range of university research activities is carried out in furtherance of the universities' exempt purposes. The specific exceptions reflect the conclusion of the Congress that income from applied research activities and technology transfers which the government otherwise encourages and subsidizes should not be burdened by a tax. These exclusions have come over the years to be accepted and applied in a variety of situations. Any change to the provisions would almost certainly be disruptive.

Finally, the Internal Revenue Code provides that operations which are carried on for the convenience of the members of the higher education community are not treated as an unrelated trade or business. As we indicated above, colleges and universities have traditionally provided a range of educational support services such as dormitories, cafeterias and bookstores, which serve the interests and meet the basic needs of students and faculty. The convenience exception is necessary to ensure the availability of these essential services, which taxable businesses may not be in a position to provide on an educationally sound and uninterrupted basis.

The present structure of the unrelated business income tax -- the basic relatedness standard and the statutory exceptions to the tax for activities that serve particular social or national needs -- is effective not only in the simpler situations of income production, but also in more complex arrangements. Recently some attention has been given to college and university activities carried on through joint ventures or in subsidiaries. There are institutional reasons (often having to do with efficiency and control or with the need to raise outside capital) for colleges and universities to enter into partnerships or joint ventures or to create subsidiaries in order to pursue certain opportunities. This choice of form, however, does not shield otherwise taxable unrelated income from the unrelated business income tax. When a college or university carries out an income-producing activity in a joint venture, its share of the income is subject to the unrelated business income tax rules just as if the activity had been conducted and the income earned directly. Similarly, income earned by a subsidiary is subject to all of the rules of present law, and will be subject to tax if the same income earned directly by the college or university would have been taxed. The interests served by the use of joint venture and subsidiary structures are thus not interests of tax-avoidance, but legitimate institutional interests of the colleges and universities.

Unfair Competition: Current Concerns

Colleges and universities in this country have long recognized that they can meet their responsibilities in the areas of education, research, and public service only if they focus their efforts over the long term. The higher education community is perhaps unique among the major sectors of our society in its ability to resist short term pressures and short term enthusiasms. One of the great strengths of our educational system is that it has to a remarkable extent operated independently of cultural fads and market fluctuations.

Over the past few years, some small business concerns have found colleges and universities occupying what appear to be opportunity slots. These businesses argue that on a short term basis they could fill those slots, and that they could profit from them, if only the operations of the colleges and universities were somehow restricted or eliminated.

The anecdotes of unfair competition come from particular small businesses that have lost what they feel to be particular profit opportunities. Although we believe that higher education should be responsive to whatever is justified in small business criticism, we also believe that the problem must be seen in some perspective. We must consider not only the nature and extent of alleged competitive abuses and the ability of present law to address those abuses, but also the social needs and national interests that are potentially at stake.

(i) Competition in Educational Support Services

Some of the anecdotes of competition involve educational support services operated on campus by certain of our colleges and universities. Complaints are made, for example, about sales of merchandise in campus bookstores, or about campus lodging or dining facilities which may overlap with local commercial facilities.

No one in the higher education community argues that colleges and universities should have carte blanche in the marketplace. To the extent that the operation of educational support enterprises does not further the purposes and functions of higher education, we agree that such operations should not benefit from our institutions' exempt status. We believe, however, that present law is sufficient in this area to prevent abuses of exemption.

It is quite clear under Internal Revenue Service regulations and rulings that the over-all exempt character of a college or university operation will not protect particular transactions within that operation from tax, if such transactions themselves do not have a sufficient nexus to the organization's exempt purpose. Thus, for example, income from the sale of advertising in an otherwise exempt college publication will be subject to tax. If a college bookstore sells stereo equipment or appliances -- and our recent inquiries indicate that there are remarkably few instances of sales of products of this nature -- those particular sales are treated as an unrelated business activity. Similarly, if the college or university operates a travel program for students or alumni, present law requires that income from the program be reported as unrelated business income, unless particular tours have a substantial educational character. If there is any question about this present law treatment of bookstore sales or tour programs, it can and should be answered by a ruling from the Internal Revenue Service. We do not condone or take lightly abuses of the law in this area, but we believe that problems of this kind can be remedied by appropriate administrative action.

College travel programs have been a subject of some controversy, and may be a good example of the confusion frequently encountered in this area. Many, probably most, college tour programs are actually conducted by private travel agencies, which pay some amount to the college for its endorsement or involvement. The amount received by the college is subject to tax, if application of the relatedness standard indicates that the college's involvement in the program does not actually promote its exempt purposes. From the perspective of the travel agency, it enjoys a profit from travel activities that probably would not have occurred but for the interest of the institution.

Travel agencies thus frequently derive a net benefit as a result of the participation of colleges and universities in travel arrangements. This is also true of the many taxable businesses which have taken over a variety of campus enterprises such as bookstores and eating facilities. The interest of higher education in campus activities is simply in seeing that the activities are carried on reliably and without interruption, in a manner that is responsive to the needs of the college community. If these needs can be met by delegating the responsibilities -- and the profit opportunities -- to taxable businesses, colleges and universities are often willing to "privatize" campus operations.

Moreover, campus stores and other service facilities are increasingly sensitive to the concerns of local merchants. A number of our stores have implemented a policy of differential pricing to discourage shopping or use of the facilities other than by students or faculty. Many have limited either their hours or their product lines, and do not advertise their services, again to avoid market competition. Our institutions are alert to this issue, are anxious not to exacerbate "town-gown" problems, and are prepared to pay tax if certain aspects of their auxiliary enterprises are found to serve non-exempt purposes.

There may, in this area, be some confusion at the margin, some particular cases in which the interests of higher education, society, and business must be balanced. There have been, for example, some complaints about sales of computers by colleges and universities to students and faculty. When we looked into the question we found that in most of these cases, manufacturers had offered the college or university very substantial price discounts for sales made to students and faculty only -- a program for which private computer retailers were not eligible.

Increased access to computers for students and faculty who could not afford the usual retail prices is important not only in connection with technological training, but more broadly as an integral part of the modern educational process. The resulting increase in computer literacy and the enhancement in technological skills is obviously of great interest to society. Furthermore, private computer vendors benefit from such arrangements. Over the long term, these programs create new generations of computer users, individuals who as adults will acquire new state-of-the-art equipment as it is developed, and who as a population will be open to expanded computer use.

This is not to say that colleges and universities should be free to move into the retail computer business. Regular retail sales of any product to the general population can hardly be said to further the higher education function. Application of the relatedness standard can and should distinguish between sales to the public that are subject to tax and special programs like computer distribution arrangements for students that further important educational objectives.

(ii) Competition in Research

Complaints of unfair competition in research are rare. Instead, there is evidence of a fruitful alliance between higher education and the small business community. Small business, unaided, cannot usually develop a sufficient research capacity to function profitably. With the help of technology transfers and with other assistance from our colleges and universities, however, small businesses can make places for themselves in the market, and can make major contributions to technological progress.

Instances of this alliance can be found throughout the country. Studies by faculty at the Massachusetts Institute of Technology, for example, have identified over 1000 new businesses that began with ideas and technology from the Institute. Most of the technology that MIT licenses (typically in reliance upon the university research and royalty exclusions from the unrelated business taxable income base) is the result of government-sponsored research, which the government encourages universities to transfer to the private sector for commercial development. MIT's technology transfer licensing program alone currently results in the start-up of six to ten new companies each year.

The University of Utah has embarked on an active program of technology licensing to small businesses, resulting in the creation of more than 20 new biotechnology and computer software firms. These companies produce infant respirators, artificial limbs and organs, new crop strains, hearing aid circuits, and technology for such diverse products as pilot training simulation computers and digital recorded discs. Similarly, research from the University of California has been licensed to small business enterprises to produce a range of important new products, including a laser DNA detector that identifies a virus minutes after the sample reaches the laboratory, a laser device to unblock clogged arteries, a cochlear ear implant to aid the totally deaf, and an anti-ulcer drug. Companies using technology licensed by Stanford University have come into being to develop and market products ranging from vaccines for immunization against common debilitating illnesses to flotation beds for premature infants. Small companies in Missouri have relied upon technology developed at Washington University in businesses involving artificial blood products, computer-aided design processes, map imaging, fiber optics, and fire control devices.

These few examples could easily be multiplied. All over the country, state universities and private universities, rural and urban universities, are carrying on research to develop technology to allow local businesses to prosper. We do not believe, therefore, that in the area of research this Committee will hear many complaints of unfair competition. You are more likely to hear, from small companies that are truly at the frontiers of technology, that they rely upon and benefit from their alliance with higher education, and that our national technological standing depends upon the health and growth of this alliance.

(iii) Competition in Public Service

In the area of public service, which our institutions have traditionally viewed as an extension of their teaching and research missions, community rather than campus needs are at issue. Here again, there may be some instances of partial overlap between functions traditionally assumed by colleges and universities and short-term profit opportunities identified by commercial businesses. Our information in this area, unfortunately, is still rather limited. Public service activities are typically not undertaken by colleges and universities for profit, and often they are conducted in concert with long-range research studies. Soil testing, to use an earlier example, may be offered as a service to local farmers in connection with a state university's teaching or agricultural extension service, or as part of a long-term study of soil fertility trends within the county or state. If we look for information as to the profitability of the testing service, we typically find that data is simply not kept that way. If we try to evaluate claims of unfair competition, again we come up against the basic fact that testing is part of a larger educational function, one often mandated by charter or state law.

Although a small testing company might wish to take over all of the business in its community, it is important to recognize that there are other interests at stake. The farmer and the farming community have practical interests in the results of the college's agricultural studies, in the assistance and counsel offered by its extension services, and in its training of young people. Moreover, the farming community has a compelling need to know that critical services will be available in good economic times and bad, whether the services themselves are profitable to perform or not. It was probably for that reason that so many states thought it necessary to formalize the public service mission of their colleges and universities. Whatever our thoughts on tax policy, we should be slow to take action that would disrupt these traditional and important relationships.

Evaluating Competition: An Approach

In any system that taxes, and thus discourages, certain activities of charitable and educational organizations, difficult judgments must be made. Those judgments are particularly difficult when the taxing system affects higher education, because as a society we depend upon our colleges and universities to promote and preserve our intellectual and economic health.

In this challenging period of our national life, we are more dependent upon higher education than ever before. In the second half of this century we have seen a decline in our heavy manufacturing industries and in the export capacity of many of our major companies. In 1950, the United States produced 40 percent of the world's goods and services. By 1980, America's share had dropped almost by half, to 22 percent. During the same period Japan's share of the world market grew from less than 2 percent to 9 percent, while Europe's share rose from 21 percent to almost 30 percent. Our society has therefore come increasingly to rely for economic vitality on its "high tech" capabilities. Our solace in the face of troubling trade statistics has been that although foreign companies operating with cheap labor and government subsidies might excel in the manufacturing process, it was this country that could generate the ideas, develop the technology, and pioneer the processes. In large part it has been small business rather than our corporate giants which have been responsible for this success in innovation -- and these small businesses have depended in large measure upon higher education for the training, support and research which have made the technological achievements possible.

Recently, however, we have seen our leadership position in technological innovation as well as in large-scale manufacturing threatened by developments abroad. In 1974 the United States was responsible for the design of 70 percent of the advanced technology in the world. By 1984 this figure had dropped to 50 percent, and some experts predict that it will decline to roughly 30 percent by 1994. Last year, for the first time since World War II, the United States ran a trade deficit in high-technology products.

In the face of these developments, we believe that our colleges and universities must be in a position not merely to continue but to enhance their contributions to the education of our young people and to the expansion of our scientific and technological knowledge. They must be in a position to continue and accelerate the development of technology that can be transferred to business for product development and marketing.

At the same time we recognize that there are independent issues -- issues of tax policy and issues of unfair competition -- that need to be addressed. We don't contend that colleges and universities should be able to expand without constraint beyond their traditional functions. We do believe, however, that debate on these questions must take account of broader issues and concerns.

There is as yet very little reliable data as to the nature, scope or competitive effects of activities conducted by the tax-exempt sector. Allegations of unfair competition have to date depended largely upon anecdote, and appear to reflect isolated abuses of the law in an otherwise sound system.

First, therefore, we need to know more about the income-generating activities of the higher education community. Our institutions would support expanded reporting and disclosure requirements, and would welcome efforts to develop a reliable information collection system. If it becomes clear, after data has been developed, that colleges and universities do in particular instances occupy what small businesses see as opportunity slots, we can then evaluate the interests at stake in addition to the simple interests of business in restraining competition. Some of the instances of competition may involve mere overlap between college and university operations and commercial opportunities in areas related to the basic exempt functions of higher education. In those cases we do not believe that the tax law should discourage the activities of colleges and universities without some assurance that business would carry on such activities on a committed long-term basis, and would fully serve the purposes toward which the higher education function was directed.

To the extent, however, that colleges and universities carry on activities that do not promote their tax-exempt purposes, there is a broad consensus within our institutions that the income from such activities should be subject to tax. We may very well find that the unrelated business income tax as it is presently structured adequately provides for this. If a systematic inquiry discloses patterns of non-compliance, however, we believe that the higher education community will support an appropriate clarification of standards and an increase in enforcement.

Conclusion

The task with which this committee has been charged -- the task of revisiting and re-evaluating the Federal income tax treatment of tax-exempt organizations -- is difficult, and sensitive, and extremely important. We don't believe that any quick conclusions are possible, and we certainly don't believe that any precipitous action could be reasonable. We know very little at this time about the nature and extent of any problems, and we surely cannot make critical changes to our non-profit sector on the basis of anecdote.

We would like to offer to the committee the assistance and cooperation of the higher education community in the study and analysis you will be undertaking. We want to be participants. We want to be fair in evaluating the issues, and we want to be responsive to reasoned criticism. However, colleges and universities also want to meet the responsibilities with which this nation has charged them, and to preserve the resources necessary for this sustained and critical effort.

TESTIMONY OF THE
ASSOCIATION OF AMERICAN UNIVERSITIES

I submit this testimony on behalf of the Association of American Universities (AAU). The AAU's membership consists of 54 public and private American universities with strong programs of graduate and professional education and scholarly research. We endorse the testimony of the American Council on Education (ACE) and wish to supplement it with this brief discussion of the Unrelated Business Income Tax as it relates to research and advanced training.

The Role of the Research University in the United States.

Universities perform a substantial part of the nation's research and development activities. Especially since World World II, the federal government has looked to universities as a source of new scientific knowledge and innovation. As a result, our colleges and universities have developed a unique national system for the conduct of basic research which system has evolved into a complex and overlapping set of connections between the federal government which requests and funds the research and the universities which actually perform the research.

This expansion of university research complemented higher education's traditional goals of teaching and preservation of knowledge. Research and advanced training go together, and the university provides for them an admirable institutional setting. As a result, the system has grown and developed because it has proven to be productive, efficient, and a powerful tool for the creation and dissemination of high-level knowledge.

The training of graduate students and post-doctoral fellows is an integral part of university research programs. The vitality of the sciences and engineering disciplines depends on the infusion of new talent, ideas, and innovation through the training of young people and the maintenance of the scientific manpower "pipeline." Equally important is the transfer of knowledge and technology that occurs when students trained at universities take their degrees and go to work in industry and the national laboratories, bringing to their work the skills and familiarity with new ideas, techniques, and technology.

Research universities, however, have not lost sight of their traditional mandates, and maintain a diverse base of functions. They are general teaching institutions, receiving their greatest public recognition in that context. They provide a broad range of public services from agricultural extension station to cultural performances and exhibitions. They also carry on the research and training that has set a world standard, and on which we depend to maintain our scientific and technological preeminence in the competitive global environment.

It is on this last point that this nation looks to its research universities particularly at this time. Since World War II, our country has been a leader in fundamental research; however, in recent years we have failed to match the economic performance of Japan with its far more limited foundation in basic science. The developing gap between our scientific success and our ability to transfer those achievements into productivity gains demonstrates that private industry cannot be relied upon as the sole bridge. Economic studies prove that the return to a private sponsor of applied research which is not directly linked to product development or industrial operations is less than one-half the return to society as a whole.[1] Not only may such research fail to produce marketable products but even when successful, competitors may also be able to utilize the results free of charge. Moreover, the distinction between basic and applied research is increasingly blurred. Those technologies which enable us to utilize basic scientific principles have become fundamental in fields such as electronics, optics, metallurgy, and genetics.

The Unrelated Business Income Tax

Section 512(b)(8) of the Internal Revenue Code (Code) excludes from the term unrelated business taxable income (UBTI), all income derived from research performed for any person by a college, university or hospital. For purposes of this exclusion, no distinction is made in the Code or Regulations among various types of research such as "fundamental" "basic" or "applied". However, the Regulations do provide that "the term 'research'" does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc." Regs. Section 1.512(b)-1(f)(4). Accordingly, the exclusion from UBTI for college and university research encompasses both fundamental and applied research up to the point of ordinary commercial or industrial operations.

---

[1] Bailey and Lawrence, "Tax Policies for Innovation and Competitiveness", April 3, 1987 at pp. 26-28.

Universities now play a significant role in bridging the gap between basic research and commercial exploitation. The conduct of appropriate applied research facilitates technological procedures which will make them more valuable to private industry. Moreover, most universities will not undertake any research, basic or applied, which does not, in the opinion of academic officers and faculty, contribute importantly to the progress of knowledge and educational opportunities for its students and faculty. Nevertheless, the specific research exclusion is necessary to ensure that university applied research is not imprudently restricted.

The specific exclusion of university research for UBTI ensures that a university which pursues a research project up to but no further than the point at which there is commercial application will not be penalized with a federal income tax burden. Thus, the research exclusion and the exclusion for royalty income are the basic incentives for universities to undertake public/private partnerships in the development of new technologies. Universities which develop projects with commercial potential must then transfer or license the results of this technology to private industry or be subject to tax. Thus, current law appropriately provides incentives for vital university research which cease--and even become disincentives--at the point where the technology becomes commercially viable and private industry can be expected to take over.

Conclusion

Colleges and universities have played and will continue to play an essential role in this nation's research and development effort. Federal policy fostering this role is reflected in federal programs, the tax code and other statutes. As you examine the Unrelated Business Income Tax provisions, we ask that you do so in this public policy context.

National Association of State Universities Land Grant Colleges

One Dupont Circle - 710
Washington, D.C. 20036

Mr. Chairman, members of the Subcommittee, I thank you for this opportunity to testify in behalf of the members of the National Association of State Universities and Land-Grant Colleges. The Association includes in its membership 149 public universities. They range in size from the University of Minnesota with 63,000 students to the University of Maryland-Eastern Shore with 1378. In state appropriations, the University of California System leads with $1.3 billion last year and, in last place, is Lincoln University of Missouri with a 1985 state appropriation of just $7 million. In 1986-87 our institutions enrolled 2.6 million students, one-fifth of the total U.S. higher education enrollment. Also in that year, NASULGC members granted 60% of all doctorates that were granted in the U.S.

Despite the variation among our institutions, members of the Association are distinguished from others by their commitment to public service for economic development. All colleges and universities have an educational purpose. Many are committed also to a research mission. Only relatively few have been committed to this form of public service as we have by tradition and by practice for more than 100 years.

Before proceeding, let me make an important note for the record, and that is that many great private institutions have assumed public service responsibilities, and their activities are every bit as important to their states and to the nation as are ours.

Our testimony, Mr. Chairman, will focus on the public service function of institutions of higher education.

State Universities and Economic Development

Public service, from the perspective of this testimony, includes those university activities that are intended to enhance the economic development of the states in which the institutions are located. In this testimony, we will cite examples to illustrate university services to farms, businesses, and industries, and we also will cite federal and state laws that encourage those activities.

It is a truism, Mr. Chairman, that state universities, as their names imply, are nothing if they are not the creatures of their states. And, most significantly from the perspective of this hearing, state universities are charged by their states to take what they have learned from research in the academic disciplines of engineering, science, agriculture, and business, and to communicate the practical results of that research to the state's private businesses and farms.

These practical services to end-users are what we mean by economic development activities. They constitute one of the core functions of our institutions. Therefore, Mr. Chairman, it is our position that income generated from economic development activities should not be taxed any more than should income from tuition.

It is important to add at this point that, just as education and research in our institutions are mutually reinforcing, so too are there important positive consequences from the interaction of economic development activities with education and research. If one visualizes graduate students working with a principal investigator on an industrially supported project, it is easy to understand how the practical experience will enhance both the research perspective of the investigator and the substantive education of the students. It is no secret that practically trained students are in great demand by private employers.

Technology Transfer

Technology transfer can be defined as the process through which research findings are put to economic uses. The professional colleges on university campuses support the various sectors of the economy through their research activities and through the education of the young (and the not-so-young).

Technology transfer takes place in many ways (research publications and professional society meetings, for example) but it takes place most effectively when the research professor or his agent takes research findings directly to the company or to the farmer.

Let's turn first to the farmer because it was in his behalf that we first became involved with economic development. Later in this testimony I will mention the land-grant legislation that began with the Morrill Act of 1862. It is sufficient for now to say that our forefathers wanted America's farmers to capitalize on the research that was conducted in our colleges, largely at federal expense. Therefore they established agricultural extension programs in each of the states. "Extension" was just what the word implies. It extends the competence of the university to those who can most benefit.

It was, and is, the job of the agricultural extension agent to take the practical results of university research to individual farms and to demonstrate exactly how research findings should be applied. As most members of this Subcommittee know, ag extension continues in much the same form today. Every farmer in the country can call on a county agent who takes questions to the university and brings back answers.

Our governments, both state and federal, quickly learned the lesson of ag extension: State universities have a vast array of teaching and research resources that can support an equally vast array of economic units, from the rural family to the small business to major companies. The states and the federal government today don't hesitate to capitalize on their investments in university research and mandate economic development services for state businesses and industries. The following examples of economic development services may be instructive:

First, an activity supported by the Sea Grant College program of the U.S. Department of Commerce. Prior to 1970, the demand for soft-shell crabs in this country was limited. In 1970, only 2.6 million pounds, valued at $1.1 million were marketed. At about that time the demand began to pick up and the federally supported Sea Grant Colleges stepped in, studied production techniques and made recommendations to the small businesses that constitute the soft-shell crab industry. The number of soft-shell shedding operations assisted by Sea Grant Marine Advisory Services increased from 2 in 1975 to 474 in 1984. In 1984, approximately 2300 independent producers marketed 8.1 million pounds of soft-shells, earning $16 million in gross income and employing 4000 workers. Also in 1984, 30,000 dozen soft-shell crabs were shipped to Japan. In this case, federally supported university efforts not only strengthened a whole industry but it put a nick in the trade deficit.

Industrial extension services are conducted by many public universities. The PENNTAP program of The Pennsylvania State University is a prototype of this kind of activity. PENNTAP reported the following success story:

A tool and die company was designing new tools for cutting metal chains but was having trouble getting the metal to the proper hardness; the president called PENNTAP for help in selecting a material that would work. A PENNTAP specialist offered suggestions for a cutting edge material and sent along additional technical information. Two years later, the president said that a new chain cutter had been developed, two new jobs had been created, and sales and production increases would allow the company to serve an expanded market. There are hundreds of cases such as this and they mean many jobs many sales and stronger state economies.

In addition to industrial extension programs such as PENNTAP, many companies bring their research needs to university campuses and the research is conducted by resident faculty with the active participation of graduate students. A good example of this kind of university-industry research relationship was described last April by President Frank Rhodes of Cornell University in testimony before the House Subcommittee on Science Research and Technology. Dr. Rhodes testified in support behalf of a national network of industrial extension programs "that would link the specialized skills of individual scientists and engineers in our research universities to the particular technological and management needs of individual companies -- large and small." In his testimony, President Rhodes cited the following example:

"A Rubbermaid subsidiary in the city of Courtland, New York has state-of-the-art injection molding machines, but sought the help of our College of Engineering for using them more effectively. The goal of the project is to reduce the cycle times without impairing product quality. The first step is to simulate and optimize mold filling dynamics for deep cup molds. In the second phase, the results of the research will be implemented in the plant. Candidates for the degree of Master of Engineering gain hands-on experience by assisting in this project under the guidance of Professor K.K. Wang." Dr. Rhodes reported that Rubbermaid's initial plan to relocate its subsidiary was modified and a major employer remained in Courtland.

Federal and State Legislation

There are many state and federal laws that mandate economic development activities of the type that I have just described. Because the laws encouraging university help for businesses are so many and varied, it is reasonable to conclude that, if our universities were unable to comply, the Congress and the state legislatures would have to establish special agencies or special institutions to do the job.

Let me briefly review several federal laws that mandate economic development services. To illustrate our case, the land-grant legislation that began with the Morrill Act of 1862 is instructive. The Morrill Act created our present system of land-grant colleges. It gave to each state a grant of land, the proceeds from which would support a college offering instruction in agriculture and the mechanic arts, not to exclude other subjects, "for the sons and daughters of the industrial classes." The Hatch Act of 1887 created agricultural research stations at each of the land-grant colleges, and the Smith-Lever Act of 1914 established an agricultural extension service in each state. Morrill and Hatch created the land-grant colleges and required that they provide instruction and research, and Smith-Lever created the extension service that transferred the benefits of research and instruction to working farmers.

The following are federal laws that adopted the "land-grant model:"

o The Water Resources Act of 1963 established a water research institute in a college in each state to conduct research on water supply, water quality and pollution. It requires the institute to provide local communities, states, and water authorities with information on the local water supply, and with recommendations for water conservation.

o The Sea Grant Act. In 1966 Congress passed "The National Sea Grant College and Program Act". Sea Grant is a federal-state matching program to support a greater understanding and improved development of marine resources. Today, a total of 29 Sea Grant programs work through established colleges and universities to provide research, education and marine advisory services to the nation.

o The Mineral Resources Act of 1979 parallels the Water Resources Act. It was an attempt by Congress to do for our non-renewable resources what the Hatch Act and the Smith-Lever Act did for agriculture. Each state with an eligible school of mines or a department of mining engineering receives an annual federal grant to support academic research and extension activities.

o Small Business Development Centers (SBDC). A small number of SBDC's opened their doors for business in 1975 and the program was formally authorized by the Congress in 1980. The SBA "Fact Sheet" describes the program as follows: "The Small Business Development Center (SBDC) program was initiated by the Small Business Administration (SBA) to widen management assistance and counseling to present and prospective small business owners. SBDC's, in effect, offer "one stop" assistance to small business

-- making a wide variety of information and guidance available in central and easily accessible locations. SBDC's are generally located or headquartered in academic institutions." It is significant and worthy of mention that the few SBDC's that are not located on university campuses are housed in state agencies.

Other federal statutes provide (or have provided) for hazardous waste research centers, for transportation research centers, for community service and continuing education programs, and for state technical services. Presently, out of concern for America's competitiveness, Congressional committees are considering a new industrial extension program and the establishment of technology transfer centers. In fact, the House passed trade bill includes a nationwide network of technology transfer centers.

Summarizing this part, federal laws have engaged the research university in a wide range of economic development activities. With the Morrill Act of 1862, Congress passed landmark legislation that forever altered the public perception of the mission of public universities. Recognizing the success of that effort, Congress has continued to call on America's great research universities for special services. The need in 1987 is at least as great as it was in 1862. Presently, when American manufacturing industries are trying hard to become more competitive, the universities are making important contributions and they can do more.

The states have not been outdone by the federal government. All of the states have harnessed the resources of their state universities for economic development. For example, North Dakota's constitution gives the state assembly the responsibility for establishing a system of free public schools including schools of higher education. In establishing the schools---

> "The legislative assembly shall take such other steps as may be necessary to prevent illiteracy, secure a reasonable degree of uniformity in courses of study, and to promote industrial, scientific and agricultural improvements." (Const. 1889,Art.VIII,sec 151)

More to the point, perhaps, is Georgia legislation establishing an engineering experiment station at Georgia Tech. The following is a quotation from the Act of 1919:

> Section 1. Be it enacted by the General Assembly of the State of Georgia, and it is hereby enacted by authority of the same, That to aid in the promotion of engineering and industrial research, and for the more complete development and utilization of the natural resources of Georgia, and for the encouragement of industries and commerce, and insuring

> the public welfare of the people of Georgia consistent with modern progress and preparedness there is hereby established at and in connection with the Georgia School of Technology, a department to be known and designated as the State Engineering Experiment Station.

A final example is Tennessee's Institute for Public Service that was established in 1963:

> "**General Provisions.**- (a) There is hereby established an institute for public service which shall operate as a division of the University of Tennessee to provide continuing research and technical assistance to state and local government and industry and to meet more adequately the need for information and research in business and government".

(An appendix giving additional examples of state statutes mandating university economic development activities is attached to this testimony.)

In this part of our testimony, we have attempted to illustrate the dependence of the states on economic development support from their public universities. More generally, it is reasonable to assert that very few state governors, if any, would embark on a substantial program of economic development without involving the state's colleges and universities, both public and private.

Recent Federal Legislation

Before concluding this testimony, I refer this Subcommittee to two very important federal laws that were passed by the Congress to encourage technology transfer between universities and private companies. The first is Public Law 96-517, "The Uniform Federal Patent Policy Act." Enacted in 1980 the law gave nonprofit organizations and small businesses the right, with few exceptions, to federally funded inventions that they develop.

Congress enacted PL 96-517 because, prior to its passage, federal agencies had an inventory of more than 24,000 patented inventions but had very little success in marketing them. Few companies would pay for the cost of product development unless they could have exclusive licenses which the government, by and large, would not give. Furthermore, companies were wary of contracting with universities for fear that the government would claim that the technologies were developed as a result of research that it had sponsored. After passage of the Act, the congressional goal of encouraging technology transfer was realized. According to NSF, total business sponsorship of university research grew by 74%, from $277 million in fiscal year 1980 to $482 million in fiscal year 1985 (in constant 1982 dollars).

A recent GAO assessment on the effect of PL 96-517 was quite positive (See GAO/RCED-87-44 Patent Policy.). GAO staff interviewed ten business executives and the report states: "Nine executives identified Public Law 96-517 as an important factor that influenced their companies' decisions to increase their sponsorship of university research. Eight executives told us that universities are more receptive to receiving corporate funding, in part because Public Law 96-517 has increased their interest in patenting and licensing technology." (Page 23)

The second important technology transfer bill became law last year as part of the Tax Reform Act of 1986. The Act provides for a new 20 percent tax credit for company expenditures on university basic research. There are restrictions on the use of the credit, but the intention of the Congress was to encourage university and industry scientists to work cooperatively in the hope that, if the very latest research findings are transferred to industry, American products will become competitive in world markets. America's research universities are grateful to the Chairman of this Subcommittee for his active and aggressive sponsorship of this important legislation.

Conclusion

Because a significant portion of this country's basic research is conducted in our nation's research universities and, because those universities have responsibilities for advanced instruction in science and engineering, Congress and the state legislatures correctly extended to them the responsibility for assisting their states in technology transfer and economic development. Furthermore, the economic development activities are supported by, and, in turn, strengthen the university's research and instruction functions. It is difficult to avoid the conclusion, therefore, that public service, as it supports economic development, is a core function of the university. When this Subcommittee considers recommendations for the full Ways and Means Committee, we hope it will continue to exempt income from this form of public service as it surely will tuition.

NOC: 6/4/87

Chairman PICKLE. Thank you. We will come back to you, Dr. DiBiaggio.

Now Mr. Steven Altman, president of Texas A&I University. Dr. Altman.

STATEMENT OF STEVEN ALTMAN, PH.D., PRESIDENT, TEXAS A&I UNIVERSITY, ON BEHALF OF AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES

Mr. ALTMAN. Mr. Chairman, I am Steven Altman, president of Texas A&I University. I am pleased to have this opportunity to testify in this review of the unrelated business income tax, from the perspective of a small, State-supported regional university. The perspective, I believe, is representative of many of the Nation's 400 regional 4-year State institutions.

My testimony is intended to supplement the written statements submitted on our behalf by the American Council of Education. A copy of my oral statement will be made available to the subcommittee, for the record, if the chairman so desires.

Texas A&I University serves the instructional research and public service needs of a vast geographic region of south Texas. From the border to the gulf shores, these lands have been best known for the great ranches, including the historic King Ranch, plentiful oil and gas supplies, an agricultural economy pressured more by prices than people, and a growing restiveness about being the forgotten part of the State.

The university grew out of the early teacher education movement, expanded its scope to meet more comprehensive demands, and today, stands as the oldest, most broad-based school in the region, enrolling over 5,000 students in six academic colleges.

With our Hispanic enrollment of 51 percent, and growing, and with the only colleges of engineering and agriculture in the region, we are well positioned to prepare professionals, teachers, and business people for future leadership, and this is extremely important in Texas, as the Mexican-American population grows, as it does elsewhere in the country.

The university's budget is $15 million from the State, $24 million from all sources. Both numbers are falling, as we endure the devastating and depressing effects of reduced oil, gas, and farm prices.

Some question my judgment about coming to Texas in time to take three budget cuts in 14 months, and now we are ready for a fourth, it appears.

But we keep our optimism and test our ingenuity, and stay dedicated to serving our students and our community. We are located in Kingsville, 35 miles southwest of Corpus Christi, and a little over 100 miles north of the border.

It is a community of 30,000 people. Unemployment has exceeded 10 percent over the last 2 years, and the population base is insufficient to provide a wide variety of businesses and services. Consequently, few are available.

The ride to Corpus Christi is just far enough to dissuade many from taking it and so a certain feeling of remoteness becomes evident.

Yet the vigor and independence of the people continue attempts to build business and the community, and the university has been an aggressive leader in these economic development initiatives. My service, this year, as president of the Kingsville Chamber of Commerce, and as a board member of our area economic development council, has attempted to insure the university's commitment to business development.

Our relationships are positive, and this is important, because neighborliness is important in a small community. We serve it, and the region, also, with a small business development center and an economic development council, regularly continuing education programs, and encouragement to our faculty to help to consult and to be in the field.

We are determined to be good citizens and to do our part to help others succeed, and I am proud of the results. Of course to run this, or any other university requires a range of other support activities to be provided.

Like other institutions, we also have an array of auxiliary services including residence halls, food services, a book store, recreation facilities, a print shop, et cetera. About 24 such activities.

These revenue-generating activities amount to approximately 20 percent of our total budget, or $5 million, annually. Our goal is to break even on them as a group. We are lucky to do so. I am sorry to report that we are still not as adept as we could be in operating these services, and we generally lose money on them.

In fact most lose more than the financial records show because depreciation is not shown in our operating statements. Yet we keep them because we believe they are necessary for us to carry out our complete educational function, and I believe that function is broader than that which occurs only in the classroom and includes the social, cultural and physical environment in which a student will grow and develop.

We have not paid unrelated business income taxes since we believe that all activities offered are directly related to our educational mission and/or because we have contracted out to private business already, those few activities which we may consider to be unrelated.

But in response to recent publicity on this subject this past spring, we reviewed all such activities and developed the university's first written policy on related activities.

We have been guided by the relatedness standard and we believe that it has worked well. We have also been guided by the fact that we note the ability or inability of local business to provide services to our campus at a reasonable price, on reasonable terms, and at a convenient location in time.

And because of our remoteness, this has been a problem for us in the past. In general, Mr. Chairman, the law works well. As the State economy has worsened, we have been forced to examine other alternatives but we find that we are not very well prepared to do so, and we have steered away from those that are not directly to our university's overall mission.

I do have a number of case examples I could provide for you, Mr. Chairman. If time were to permit, perhaps we could get back to those, but they would generally indicate that we have attempted to keep a neighborly attitude with private business in the region, that we have operated activities for the benefit of our educational mission on campus and it has worked very well.

[The statement of Mr. Altman follows:]

Statement of the American Association of State Colleges and Universities

Texas A & I University serves the instructional, research, and public service needs of a vast geographic region of South Texas. From the border to the Gulf shores, these land have been best known for the great ranches, including the historic King Ranch, plentiful oil and gas supplies, an agricultural economy pressured more by prices than people, and a growing restiveness about being the forgotten part of the State. As a publicly supported AASCU institution, the University grew out of the early teacher education movement, expanded its scope to meet more comprehensive demands, and today stands as the oldest, most broad based school in the region, enrolling over 5,000 students in six academic colleges. With our Hispanic enrollment of 51%, and growing, and with the only colleges of engineering and agriculture in the region, we are well positioned to prepare professionals, teachers, and business people for future leadership. This is extremely important as the Mexican-American population of Texas, and the country, expands rapidly.

The University's budget is $15 million from the State and $24 million from all sources. Both numbers are falling as we endure the devasting and depressing effects of reduced oil, gas, and farm prices. Some question my judgment in coming to Texas in time to face three budget cuts in 14 months, and we are ready now to take the fourth. But we keep our optimism, test our ingenuity, and stay dedicated to serving our students and our communities.

We're located in Kingsville, 35 miles southwest of Corpus Christi, and a little over 100 miles north of the border. A community of 30,000 people, Kingsville prides itself on its hospitality, its independence, its being home to the largest U.S. ranch, and its two largest employers: Kingsville Naval Air Station and Texas A & I University. Unemployment has exceeded 10% over the last two years, and the population base is insufficient to support a wide variety of businesses and services. Consequently, few are available. The ride to Corpus Christi is just far enough to dissuade many from taking it, and so a certain feeling of remoteness becomes evident. Yet the vigor and independence of the people continue attempts to build business and the community, and the University has been an aggressive leader in these economic development initiatives. My service this year as president of the Chamber of Commerce, and as a board member of our Economic Development Council, has attempted to assure the University's commitment to business development.

Our relationships are positive, and this is important because "neighborliness" is important in a small community. We serve it and the region, also, with a Small Business Development Center, a University Economic Development Council, regular continuing education programs, and encouragement to faculty to help, consult, and to be in the field. We are determined to be good citizens and to do our part to help others succeed. I'm proud of the results.

Of course, to run this or any other university requires a range of other support activities to be provided. Like other institutions, we also have an array of auxiliary services, including residence halls, food services, a bookstore, recreational facilities, a print shop, etc. A complete listing is attached. These revenue generating activities amount to approximately 20% of our total budget, or $5 million annually.

Our goal is to break even on them, taken as a group. We're lucky to do so. I am sorry to report that we are still not as adept as we could be in operating these services, and we generally lose money on them. In fact, most lose more than the financial records show, because depreciation is not included in our operating statements. Yet we keep them, because we believe they are necessary for us to carry out our complete educational function. And I believe that that function is broader than what occurs only in the classroom, in that it includes a complete social, cultural, and physical environment in which a student grows and develops.

We have not paid unrelated business income taxes, since we believe that all activities offered are related directly to our educational mission, and/or because we have contracted out to private business already those few activities which may be considered unrelated. In response to recent publicity on this subject, however, this past Spring we reviewed all such auxiliary units, and developed the University's first written policy on Related Activities. A copy is attached.

Decisions have been guided by the relatedness standard. They have been significantly influenced by the ability (or inability) of the local business community to provide the service at a reasonable price, on reasonable terms, and at a convenient location and time. Because of the University's location, this has been an important attribute. Over the last two years, the University has contracted out to private companies responsibility for food services, child care services, and will soon do the same for the bookstore. We wish there were more opportunities for contract services, because, in general, the University is not organized to run them as they should be managed,

The law works well. As the state economy has worsened, we have been forced to examine other revenue alternatives. However, as we evaluate them, the most important criterion was the extent to which the activity was related to our overall mission. Matters of taxation were secondary; it was more important to stay with things we knew at least a little about. Further, we have neither the scale nor the capital nor the markets to consider major expansions.

Four brief case examples may illustrate the issue involving taxes, competition, and cooperation with small business.

(1) Campus Bowling Alley

The campus bowling alley is used primarily for Physical Education courses and two-thirds of its budget comes from student fees. In the evening leagues are sponsored. The owner of the only bowling alley in Kingsville complained that we were unfairly competing with his establishment because some non-University people were playing in the evening leagues. We reviewed our policy (and practice), and revised it to restrict league play to University students, faculty, staff, and their families. The disagreement was resolved quickly and amicably.

(2) Campus Pub

The campus Pub has been a favorite social center on campus. With few restaurants and cocktail lounges in town, students naturally congregated there to drink beer, watch TV, and blow off steam. It was modestly profitable for many years, with the proceeds being returned to support other student activities. Last year the drinking age in Texas increased to 21, and attendance at the Pub has dwindled. We now lose money there (at a greater rate than we once made it), yet we continue to operate the facility because it does serve an important purpose on campus. We could not expect an outside contractor to continue this service based on its current revenues.

(3) Citrus Research Center

The University operates a nationally distinguished Citrus Research Center. Among other innovations, it developed two of the best selling grapefruit produced in Texas, the Star Ruby and the Rio Red. The Center raises and sells grapefruit as a result of its research program. However, rather than selling its fruit at very low prices, since land and personnel costs are not included, it sells them to co-ops at market rates. This is the same price paid to all commercial growers. The volume produced at the Center is not sufficient to affect the price, and all revenues are returned to the research fund to support further varietal development. Because of the Center's work, the entire industry in the Rio Grande Valley has benefitted because they all grow the Center's grapefruit, and all avail themselves of the latest research on disease, pesticides, and insect control.

(4) Facility Rentals

We believe we have the finest physical facilities in the region, and receive regular requests from the public to use them for meetings, weddings, parties, or private conferences. The University System of South Texas, of which we are a member, adopted a policy several years ago to restrict use of these facilities to sponsors with University affiliations. This was done to protect the facilities, but also to avoid competition with other restaurants, halls, or offices in Kingsville which would prefer to handle the business. Even when there is obviously no alternative, i.e., a banquet of 500 people, we still insist on a University affiliation for sponsorship.

These examples are designed to show that the University operates revenue generating activities only when they are related to our broad mission, that most lose money, and that we take pains to avoid unfair competition with local business, Further, because of our commitment to economic development, a cooperative partnership is important. The law has worked well for us, and we are undoubtedly typical of most AASCU institutions around the country. With the state of the economy now in Texas, I can assure you that we intend to stay positive in our approach and mindful of our purposes.

Thank you.

Attachments

AUXILIARY SERVICES AND OTHER REVENUE GENERATING ACTIVITIES

Texas A & I University

Bookstore
Museum Gift Shop
Newstand
Food Services
Residence Hall
Vending Machine
Concession Stand
Bowling Alley
Rifle Range
Tennis Courts
Print Shop
Child Care Center
Student Newspaper
Radio Station
Pub
Citrus Research Center
University Farm
Continuing Education Programs
Small Business Institute
Analytical Instruments Laboratory
Computer Sales
Facility Rentals
Alumni Association
Foundation Income

Chairman **Pickle**. Mr. Altman, you say you could give us some examples of the type of income that you have in the related field. Does your testimony include those examples?

Mr. **Altman**. Yes, sir.

Chairman **Pickle**. We do not have a copy of your testimony yet. I would want to say to other witnesses, particularly tomorrow, and from now on, the committee expects a copy of your statement.

Some of the witnesses here this morning have not given us a statement ahead of time, and other than in your statement which we are glad to receive, we do not know how far to go.

So I am serving notice now, if you want to testify, we should have a copy of your testimony in the committee's hands, and I am sure that is agreeable to the committee, because we need that information.

We had two witnesses this morning, and you talked in general terms of relatedness or convenience, and applied and basic science approach, but we have not gotten any real examples.

I want to say to you that the staff is now going to follow through and contact your university. We want to know what are you dealing in; what are you, quote, "selling"? We want a "bread and butter" example, and not just so much theory, and then we will try to apply the theory to it. So we are asking your cooperation in that respect.

Now, the next witness will be Mr. Mason representing the National Association of College and University Business Officers. Mr. Mason.

STATEMENT OF THOMAS MASON, VICE PRESIDENT OF THE UNIVERSITY OF NOTRE DAME, ON BEHALF OF NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

Mr. **Mason**. Mr. Chairman, members of the committee——

Chairman **Pickle**. Are you submitting a statement?

Mr. **Mason**. I believe a statement has been submitted and I intend to just amplify and to bring into play the experience of the University of Notre Dame in relation to unrelated business income.

I am pleased to submit this statement on college and university business operations and unrelated business income on behalf of the National Association of Colleges and Universities, an organization of 2,100 colleges and universities.

The environment in which colleges and universities operate has undergone radical change and has become increasingly complex.

Today, campus management is comparable to managing a small city with land, buildings, police and fire departments, powerplants, utility systems, roadways, vehicles, housing, restaurants, and retail stores.

There must also be considered environmental protection provisions and other aspects of Federal regulations. When colleges and universities participate in activities substantially unrelated to their tax-exempt purpose, and otherwise not designated as exempt, current law states that any resultant income be subject to taxation.

Through its participation and business administration manual, NACUBO sets forth the sound and proper management practices, and requirements of the law for institutions to follow.

NACUBO believes that almost all, if not all institutions of higher education, one, operate business and financial functions at a high level of integrity, second, follow sound and proper business practices, and, third, are willing to be held accountable for their actions.

The current unrelated business income laws and regulations, if properly enforced, appear to be adequate to meet the purposes for which they were established.

We must ensure there are not flagrant violations. Certainly, colleges and universities must be sensitive to the competition issue.

In the case of the University of Notre Dame, we were audited by the Internal Revenue Service in 1979 as part of a pilot project. The Internal Revenue spent 18 months on our campus examining various issues.

We have been filing a 990T. The type of activity that we have agreed with the Internal Revenue is subject to the unrelated business income tax are such activities as certain activities of our athletic and convocation center. This is a major arena in which such things as concerts, ice capades, and those type of activities may take place.

I might point out that most of these activities such as ice capades are also, we believe, part of our community responsibility. That is to say, we are in a semi-rural area. If we did not offer our facilities for use in these kind of situations, the next-closest facility available might be 75 to 100 miles.

So we do not believe that we are competing, even though we agree that it is unrelated. The second item of unrelated on our 990T would be certain aspects of our bookstore operation.

The third item which caused our president, who is now retired—I am not sure whether that caused him to retire or not—but we operate a cemetery and the Internal Revenue determined that that was an unrelated business income.

We did not argue the case. Certainly, it is available to staff and alumni. We have operated it for over 100 years. It does not make a profit. Our computing operation—as was pointed out by others here this morning—we do sell a limited amount of service to some companies in the community who do not have the capability of having their own computing operations.

Certain aspects of our continuing education center were deemed to be taxable. That is to say, where the facility was being utilized but where our faculty was not directly involved in the activity, and so we were in effect renting space.

Our golf course, as was mentioned a few minutes ago, was also determined to be taxable in terms of certain aspects of it related to downtowners, or alumni playing golf.

We also operate on the campus the Morris Inn which is a 100-room facility, which we use for official entertainment, official guests. We are, as I say, a rather rural campus, and we do operate the inn for the convenience of our guests, and certain aspects of that were determined to be also taxable.

Some of our summer activities were examined. Food sales and summer lodging, where we sponsor sports camps and those kind of activities, were also determined to be taxable. As I mentioned, some of the activity we are involved in we believe is community related, and we are willing to concede it is unrelated business income but we do not believe we are in competition with anybody, or that it is hurting anybody.

We, this summer, will host the International Special Olympic Games. We will have on our campus about 6,000 handicapped participants. We will have about 30,000 volunteers participating in those activities.

We are not doing this as a competition in relation to anybody else. We are doing it as a community, as a university interested in those type of activities, but I am sure that some of that activity will be construed to be unrelated business income tax and we will have to file that on our 990–T.

I would also point out that we do have substantially good relations with small business in our area. We do have on our campus branch banks operated by the downtown bank. We do have travel agencies on our campus operated by commercial travel agencies.

We have hair stylists. We have commercial catering operations.

In conclusion, if it is found that collection of additional information would be beneficial to compliance and enforcement of the unrelated business income tax law, NACUBO would be willing to assist the subcommittee, and the Internal Revenue Service in such an effort.

Mr. Chairman, and members of the committee, I thank you for the opportunity to provide this testimony, and, on behalf of NACUBO, I would be pleased to answer any questions you may have.

[The statement submitted by Mr. Mason follows:]

Statement of the National Association of College and University Business Officers, National Association of College Stores, Inc., and the National Association of College Auxiliary Services

Mr. Chairman and members of the Subcommittee, I am pleased to submit this testimony on college and university business operations and unrelated business income tax on behalf of the National Association of College and University Business Officers (NACUBO), an association representing more than 2,100 colleges and universities, the National Association of College Stores, Inc., and the National Association of College Auxiliary Services. This testimony is provided to assist the Subcommittee on Oversight, Committee on Ways and Means in its review of income-producing activities of tax-exempt organizations under section 501 of the Internal Revenue Code.

NACUBO's mission is to promote sound management and financial administration of colleges and universities. A major association goal is to promote professional standards and ethical conduct for management and financial administrators of higher education. This past year, in recognition of the importance of the business competition issue, NACUBO has sponsored a policy task force on business competition that includes representatives from small and large, two-year and four-year, and public and private institutions.

My remarks will address a concern for the financial viability of higher education institutions and will be presented from the perspective of the college and university business officer and the responsibilities this position has for campus educational and business support activities. I will provide background on actual campus business activities and some of the issues and problems facing colleges and universities today. Activities related specifically to major research programs will not be addressed since this area will be covered by other testimony to be presented to the Subcommittee. It is hoped that these facts will assist the Subcommittee in its review of this important matter.

BACKGROUND

College and universities have traditionally engaged in activities intended to provide service to their faculty, students, and staff, such as the operation of bookstores, dormitories, and cafeterias. In some cases, these activities have been in place for more than 100 years. During the past 25 years, colleges and universities have experienced financial, social and technological pressures due to new responsibilities, increased costs, shifts in sources of funding, expansion of the student population, particularly non-traditional students, and requests to transfer technology developed through campus research. The work of the NACUBO Task Force indicates that the growth in many of the campus educational support activities during this time period was in direct proportion to the growth in the student population. Some of the activities undertaken during this 25-year time period were also due to changes in technology and changes in the needs of employees and students. Two examples of these changes are the need for computers in the educational process and day-care centers. In response to these pressures, colleges and universities have paid increased attention to the examination and planning of their activities that produce revenue.

The environment in which colleges and universities operate has undergone radical changes and have become increasing complex. Today, campus management is comparable to managing a small city--with land, buildings, police and fire departments, power plants, utility systems, telephone systems, roadways, transportation vehicles, housing, restaurants, retail stores, and they must manage and control hazardous waste. All of these necessary and required functions result in increased costs and governmental regulations.

CURRENT CHALLENGES

There are many challenges to be met to maintain the rich heritage American higher education has provided through teaching, research, and public service and to make higher education increasingly available to all members of our society. Today higher education must also meet and serve the needs of a rapidly changing and increasingly technically complex society. From the perspective of the college and university business officer, these are some of the problems and issues that are present:

- Faculty salary increases are now required because cost-of-living increases were not maintained during the prior period of inflation.

- Experienced and highly qualified faculty and staff are being lost to business and industry because of offers of higher salary and employee benefits packages.

- Operating costs are increasing--one recent study indicated that in the past 10 years there has been an increase of 306% in utility costs, 149% in books and periodicals, 122% in supplies and materials, 100% in contracted services and 185% in fringe benefits.

- Accumulated deferred maintenance on many campuses has reached major proportions. In 1985 the estimated total replacement cost of higher-education physical plants was $250 billion; a very conservative cost estimate of currently needed physical plant improvements or replacements is $62.5 billion or 25% of the estimated 1985 cost. Deferred building and equipment maintenance and obsolescence due to new technology is now a major problem on many campuses.

- Many new federal regulations have been mandated--for example in the areas of hazardous waste and immigration--and compliance with these regulations increases operational costs.

- Criticism occurs when tuition costs are increased to meet many of the required and uncontrollable costs.

- Municipalities are now charging "user fees" for services previously provided without charge.

SOLUTIONS SOUGHT

Federal contributions to higher education could not be expected to increase forever, so higher education had to look for ways to maintain revenues. To accomplish this, institutions have turned to varied and alternative means to meet increased costs for campus programs and new demands for services from faculty, students and staff. In seeking ways to enhance revenues and reduce costs, institutions have studied alternative ways to; (1) control costs for necessary campus services; (2) provide needed services of priority to faculty, students, and staff; and (3) stay current with new technological changes. New responses include the establishment of "enrollment management" offices to attract students, the development of new programs to meet the needs of the growing adult and part-time student population, the development of linkages with the business community, and the creation of innovative financial-aid programs to assist students in meeting costs of attendance.

Colleges and universities have had to review their assets and operations to determine the potential for generating revenue. Some of these activities include (1) developing research and development centers; (2) rental of buildings during short-term idle periods; (3) patenting and licensing programs, whereby technology developed by campus research programs is transferred to the corporate world; (4) selling of software developed for academic or administrative purposes; (5) improving campus retailing activities; and (6) utilizing self-operated vending machines.

Many of these activities are accomplished with assistance and cooperation from business organizations, and benefits are provided to both the institution and the business organization. One innovative example of mutual benefits was the creation by a university of a "campus mall" and the invitation to various businesses to consider leasing space in the mall to provide services for faculty, students, and staff.

RELATED EDUCATIONAL ACTIVITIES

Various structures are used to establish and manage related educational activities (auxiliary services) to support students and the learning process. Almost every institution operates and controls one auxiliary service managed by employees of the institution. Other structural forms designed to accomplish fulfillment of the institutions mission and related activities include cooperatives, for-profit subsidiaries, non-profit subsidiaries, auxiliary non-profit corporations and contract management.

The College and University Business Administration manual published by NACUBO describes the four common elements of auxiliary services:

- o They furnish a service to faculty, students or staff.
- o They are essentially self-supporting.
- o They support an institution's educational program.
- o They may incidentally serve the public.

Services provided directly or indirectly to students, faculty or staff are paid for by a fee related to but not necessarily equal to, the full cost of the service provided. Services provided by auxiliary operations are important elements of an institution's educational program. The National Association of College Auxiliary Services now lists 76 operational areas that today are considered auxiliary services at various institutions of higher education.

These operational areas include student dining and snack service, student housing, student union/campus centers, bookstores, print shops, security and safety, alumni associations, banks, conference centers, telecommunications, airports, custodial services, newspapers, post offices, bus service, central stores and maintenance services. These functions are an integral part of campus operations and provide necessary services for the university community. They generally do not produce excess revenues. If any excess revenues are generated by these activities, many institutions use these funds to support institutional student financial aid programs and general operating costs.

COMPETITION

The higher education community is aware of some of the complaints of unfair competition that have been raised in recent years and that are scheduled for review as part of these hearings. Many of the complaints are related to some of the operations on the list I have just enumerated. None of us in the higher education community would say that institutions must have a monopoly on providing certain service activities, but we do think it must be recognized that certain services are essential to the educational system on a long term basis. These services must be provided over the long haul, even if they cannot operate on a self-sustaining basis.

When colleges and universities participate in activities substantially unrelated to their tax-exempt purpose and otherwise not designated as exempt, current law states that any resultant income is subject to taxation. Through its publications and business administration manual, NACUBO sets forth sound and proper management practices and the requirements of the law for institutions to follow. Through the Policy Task Force on Business Competition, NACUBO has reviewed policies and practices of institutions related to the sale of goods and services. Examples of excellent management and compliance policies and procedures are currently being made available to all our members.

A goal of the NACUBO Task Force effort has been to encourage institutions to review their various campus education business support activities. NACUBO has been pleased to learn that several institutions have recently reviewed their own practices in this area and have developed policies and procedures that demonstrate fair and sound business management, along with compliance with current laws and regulations. For example, one institution requires the completion of a questionnaire for each activity unit that has the potential for generating unrelated-business income and a followup financial worksheet is required for identified areas when the activity is found to be unrelated to the exempt mission of the institutions. Another institution has a policy that clearly states that when providing goods and services for fees it must be mindful that it may be competing with local private businesses. A third institution has a policy that states that business enterprises and services operated or authorized by the institution shall generally be permitted (1) when economically feasible, (2) necessary for conducting the mission of the institution and (3) when comparable goods or services are not readily available to meet the express needs of the institution.

It should be noted, however, the generation of unrelated-business income does not always produce taxable income, since direct costs incurred in generating the income are deductible. Many times this situation is present because the service mission of an institution to its students has priority over any revenue motive.

COMMUNITY AND PUBLIC SERVICE

Colleges and universities include community and public service as part of their mission and responsibility. Community colleges in particular make community service a direct part of their mission. Special education programs are sponsored to meet and serve community needs. Many cultural events, library services and student performances are available to the public. Colleges and universities also contribute to the local economy through their day-to-day operations and by attracting businesses to the local area. Some large state universities operate services that permit students to have practical experience in their professional field and in turn provide services to the community.

To avoid competition with similar local private services, an institution may provide only very specialized services not available locally or limit the amount of such services provided. For some services, an institution may also deliberately charge higher rates than local commercial facilities in the area to limit request for services. In these situations institutions try to avoid competition with local business and conduct their activities on the most modest scale that meets their needs and that in turn will not diminish local business trade.

Some colleges and universities, as part of service activities, sponsor special programs to advise and assist small business owners. On occasion, institutions have been asked by government agencies to provide consulting services to local businesses.

CONCLUSION

By this testimony, I have attempted to provide information to the Subcommittee on business activities that support the educational mission of colleges and universities. Colleges and universities have the responsibility to meet students academic and educational related needs, and to establish functions to support these responsibilities. On a whole colleges and universities have acted with concern for the business competition issues within their community. NACUBO sincerely believes that if these activities are understood and viewed within the educational mission and the current technological and economic environment, many concerns and misunderstandings will be resolved. NACUBO finds that almost, if not all, institutions of higher education are (1) operating business and financial functions at a high level of integrity, (2) following sound and proper business practices and (3) willing to be held accountable for their actions.

When colleges and universities make a decision to participate in activities that do not substantially relate to the educational mission, they become subject to unrelated business income tax laws and pay taxes when appropriate. If the activities are important to institutional goals and are financially sound, the action to proceed is made on that foundation.

The current unrelated business income laws and regulations, if properly enforced, appear to be adequate to meet the purposes for which they were established. Certainly, colleges and universities must be sensitive to the competition issue and we must insure there are not flagrant violations. Competition however is not automatically unfair.

If it is found that the collection of additional information would be beneficial to compliance and enforcement of the unrelated-business income law, NACUBO would be willing to assist the Subcommittee and the Internal Revenue Service in such an effort. Mr. Chairman and members of the Committee, I thank you for the opportunity to provide this testimony and on behalf of NACUBO and the other named associations, I will be pleased to answer any questions you may have.

Chairman PICKLE. Thank you, Mr. Mason. Now we will ask Dr. Robert Bruce, representing the National Association of Independent Colleges and Universities. If you will proceed, sir.

STATEMENT OF ROBERT J. BRUCE, PH.D., PRESIDENT, WIDENER UNIVERSITY, ON BEHALF OF NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

Mr. BRUCE. Thank you, Mr. Chairman. I apologize for not having the testimony in front of the committee. I was a late addition, and it will be distributed this morning.

I am Robert Bruce, president of Widener University, and I am pleased to have this opportunity to appear before you, for I believe that Widener is representative of many of the member institutions of the National Association of Independent Colleges and Universities.

Obviously our presence here shows our concern. We are aware of the public concern with this issue. I might add, parenthetically, that Widener, despite its active involvement in many areas, which I will briefly touch upon specifically today, has not received any complaints from the business community on our activities.

Specifically, similar to other universities around the country, Widener has undertaken several programs and activities which support the educational mission of the institution, but which do not represent traditional instructional services.

At Widener, the one most notable activity is our operation of a 154-room Sheraton Hotel. The university acquired the hotel in 1982 in order to provide the students in our school of hotel and restaurant management with a professional laboratory in which to learn their skills.

The hotel is operated by a fully taxable for-profit corporation, Innkeepers of Delaware, Inc., which is wholly owned by the university. As a Delaware business corporation, Innkeepers of Delaware, Inc. is subject to Federal and Delaware corporate taxes just as any other franchisee of the Sheraton Corp.

We charge rates comparable to other hotels. We do not discount for the university visitors. The hotel is run by a professional staff and assisted by our students.

Widener also contracts with the IBM Corp. to sell computers at a 30-percent discount to our students and faculty. We do this in order to provide the lowest cost available state-of-the-art equipment to our students and faculty.

The university does not derive any profit from the service, the discount is passed through to the students and the faculty who purchase the equipment.

No one other than current students or members of the faculty are allowed to participate in this discount. As has been stated, Widener also derives income from leasing its facilities. However, in our case, this is usually just enough to cover the overhead and the cost of the facilities.

These are usually community groups that use our services. We permit local groups to use the facilities, such as for example, local government groups. We permit local community groups to hold meetings, high school commencements, et cetera. We do not make money; we break even at best.

We also provide a number of services to students, as has been mentioned by the other witnesses, such as, our on-campus housing, the sale of personal computers and other educational focuses.

I might, in conclusion say, that similar to other colleges and universities in the country, sir, Widener makes a serious effort to respond to our community needs, including local business.

We host the Administration Small Business Development Center. Through this we help entrepreneurial businesses get started at no cost to them for the expertise.

We participate in Delaware County which has a very active public/private economic development partnership in attempting to promote business in the community by serving as the educational wing of this partnership.

When several local businesses closed down, we, along with other universities, did retraining programs. Since we are located in a city that is one of the most depressed in the country, we find that many of our services that are done at cost inure for the benefit of the entire community.

Mr. Chairman, I realize that this committee has an important task, and I request that you be sensitive to educational needs so we may remain innovative to properly serve our students and our communities.

It is a difficult question. I do know that there are certain instances that perhaps need to be looked at, but I do believe that the current law provides sufficient strength to do so.

I thank you, sir, for allowing me to testify.

[The statement of Mr. Bruce follows:]

TESTIMONY OF ROBERT BRUCE
PRESIDENT OF WIDENER UNIVERSITY
APPEARING ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

Mr. Chairman, I am Robert Bruce, President of Widener University. I am delighted to have this opportunity to appear before you as you begin your review of the unrelated business income tax, since Widener is representative of many of the member institutions of the National Association of Independent Colleges and Universities. As I hope is clear to you by our presence here today, this is an issue which is of concern to colleges and universities, whether large or small, public or independent. We are concerned not because we engage in activities that are inappropriate or which generate large sums of money; we generally do not. We are here because of our concern about the potential effects upon the quality of the education and educational support services we provide.

I might add, parenthetically, that Widener, despite its active involvement in many areas, which I will address today, has never received any complaints from the business community on these activities.

I would like to talk with you briefly about Widener University and Widener's activities. Until the middle 1960s, Widener University was known as the Pennsylvania Military College, a men's institution which focused upon military education. Through a series of changes -- including the admission of women in 1966, the acquisition of or merger with two other institutions of higher education, and a restructuring of the institution into a regional university -- Widener has become a complex and educationally diverse institution. Widener has grown from an institution with fewer than 1400 students in 1975 to a university with more than 7800 students pursuing 54 separate programs of higher education. Among our two- and four-year programs for undergraduates, we offer the arts and sciences, hotel and restaurant management, business management, engineering, educational, and nursing. We also offer 33 graduate degree programs.

Similar to other universities around the country, Widener has undertaken several programs and activities which support the educational mission of the institution, but which do not represent traditional instructional services. At Widener, the most notable of such activities is our operation of a 154-room Sheraton Hotel. The University acquired the hotel in 1982 in order to provide the students in our School of Hotel and Restaurant Management with a professional laborabory in which to learn their skills.

The hotel is operated by a fully taxable for-profit corporation, Innkeepers of Delaware, Inc., which is wholly owned by Widener University. As a Delaware business corporation, Innkeepers of Delaware, Inc. is subject to federal and Delaware corporate taxes just as any other franchise of the Sheraton corporation.

We charge rates comparable to other hotels and do not discount the rooms or meals for University visitors. The hotel is run by a professional staff with many of our students working with the professional staff of the hotel. For example, during the fall and spring, our students operate in the restaurant three evenings a week to plan, prepare, market and serve a meal offered parallel to the hotel menu. This is charged at regular hotel restaurant rates.

Widener also contracts with the IBM Corporation to sell computers, at a 30 percent discount, to our students and faculty. We do this in order to provide, at the lowest cost available, state-of-the-art computer equipment. Widener does not derive any profit from this service; the discount is passed through to the students and faculty purchasing the equipment. We do not allow anyone other than a current student or member of the faculty to purchase these computers.

Widener also derives income from leasing its facilities. However, this income is only to cover overhead and direct costs. These arrangements take three forms. First, in order to cover costs for our maintenance and food service employees during the summer and other nonacademic periods, we permit outside groups to rent some of our facilities. These groups typically have some relationship with the campus or some educational mission to their meeting. Second, we permit local groups to use our facilities to help meet the needs of the local community: Typically for a fee which covers overhead and basic expenses, we permit local high schools to use our track and indoor athletic facility for meets, the student center for graduation ceremonies, and local community and government organizations frequently hold meetings in our larger meeting spaces as a service to the community. Third, we lease space in our student center to outside merchants who are providing important services to our students, such as those which operate our bookstore, a bank, and up until three years ago, a barber shop.

Widener itself provides a number of services to students on the campus as an essential, albeit indirect, part of the educational process. For example, our on-campus housing, which provides students with convenient and affordable housing, also helps to create the collegial atmosphere which is such an essential part of the educational process. We provide a wide range of programs in our dormitories, including seminars, peer counseling and social activities. In a similar vein, we make available counseling services, micro-computer and language laboratories, health services, and athletic facilities, each of which are realistic and important dimensions to serve the needs our students bring with them to campus.

Before I conclude, I want to make one final point. Similar to many other colleges and universities in this country, Widener makes a serious effort to respond to the needs of its community, including those of local businesses. Widener is a host to the SBA's Small Business Development Center in the region. Through this Center, our faculty, with undergraduate student assistance, provide technical and conceptual expertise to developing small businesses. They help set up books, create accounting systems, and develop marketing plans for entrepreneurs requesting such assistance.

The University looks upon its community as a laboratory resource, not a competitor.

In Delaware County, PA, there is a very active public/private economic development partnership in which Widener plays an active role. This partnership, which includes county government, education and business, works to develop cooperative efforts to attract support and maintain business activities in the county.

Additionally, Widener co-sponsors a private-sector economic incubator. We structure and create educational programs in response to the needs of the employers and the employees in our area. The majority of our graduate students are evening students, working full time in local businesses. To accommodate their schedules, we hold classes year round in the evening; we have even sent our faculty to local business sites to conduct classes. When several local businesses closed down, we provided employment retraining programs for displaced workers. This same commitment to being a good citizen prompts us to send students to assist over 5000 low-income individuals with preparation of tax returns; to provide law-student operated-free client clinics in Chester, one of the nation's most economically depressed cities; to open our libraries to students from local high schools; to allow local high schools to use our facilities for their graduation ceremonies; and nursing students provide care to the elderly as well as child centers.

Lastly, Widener, as one of the largest employers in the city of Chester, generates through payroll taxes and purchases, some $75 million for the area economy. Real estate values in the area of the University have increased their value at a higher rate than any other section of the city.

Mr. Chairman, I realize this subcommittee has an important task before it. I urge you to be sensitive to our need to remain innovative in order to properly serve our students and our neighbors. The present law permits this. To place further financial burden on our higher educational institutions at a time of declining federal support will be counter productive to our mission to produce the skills necessary for this nation to remain competitive in the world's economy. I would also remind you that the task which lies ahead of us will require more creativity and collaboration than has been necessary in the past. Thank you for your time.

Chairman PICKLE. Thank you, Dr. Bruce. Now our last witness will be Mr. Jeff Carr, vice chancellor for university relations and general counsel, Vanderbilt University.

STATEMENT OF JEFF CARR, VICE CHANCELLOR FOR UNIVERSITY RELATIONS AND GENERAL COUNSEL, VANDERBILT UNIVERSITY

Mr. CARR. Mr. Chairman, and Members, Vanderbilt is an independent university with 9,000 students, and 10 schools, including a medical school and a medical center, and is located in Nashville.

When Congress enacted the unrelated business income tax in 1950, there were two objectives: to prevent unfair competition and to generate additional revenue.

Unfair competition was a concern at that time because of the growing practice of universities in the late 1940's of acquiring profitable taxable businesses, and operating them tax-free under the exemption granted the institution. It was feared that this practice, if left undiscouraged would grow and over time, taxable competition would be driven from the marketplace.

Measured against that objective, the unrelated business income tax has proven itself effective.

The enactment of the unrelated business income tax stopped, as it should have been stopped, the acquisition and transition to exempt status by universities of unrelated profitable businesses.

At the same time, taxable businesses, rather than being prejudiced by the activities of universities, enjoy new marketing opportunities when the long-term results of university research reach the marketplace and generate profit primarily for taxable organizations and individuals.

The purchasing power of the institution and its faculty, staff, and students, also presents marketing opportunities for the profit sector. Within the immediate vicinity of Vanderbilt, for example, there are over 50 restaurants drawn to a market that is largely created by Vanderbilt's presence, notwithstanding that the university operates its own dining halls for students who choose to use them.

Measured against the objective of generating additional tax, the unrelated business income tax has not been a large revenue producer, and it is predictable that any extension of its application would generate little, if any, additional tax revenue. Universities have traditionally not accounted for expenses with the same methodology used in the taxable sector. Depreciation, for example, is an expense item that typically has not been shown on the operating statements of universities.

Of particular interest to Vanderbilt, current tax policy allows the joining together of profit and not-for-profit partners in creative and productive ventures not possible by either partner alone. With new leadership and new faculty, Vanderbilt's Department of Psychiatry 4 years ago, identified the need for additional in-patient beds to complement its teaching, research and clinical treatment programs. The particular interest was a larger patient base for adolescent psychiatric patients, a response to the growing national problem of chemical dependency and other psychiatric needs among our Nation's young people.

Vanderbilt had the location and the professional faculty talent to support an additional facility, but not the capital. A partnership with Hospital Corp. of America (HCA) was developed, under which an 88-bed child and adolescent psychiatric hospital was built at Vanderbilt, staffed by Vanderbilt University faculty, financed by HCA capital, and utilizes administrative services provided by HCA.

Before proceeding, a ruling was requested from the Internal Revenue Service. That ruling determined that Vanderbilt's participation was in furtherance of its exempt purposes, and Vanderbilt's share of any excess of revenue over expense would not result in unrelated business income.

This child and adolescent psychiatric hospital would not and could not have been built and operated without the unique contributions of both Vanderbilt and HCA. Collaborations of this nature should be encouraged, and not discouraged through a change in tax policy. At Vanderbilt, we file form 990-T. We report relatively small amounts of income, perhaps in an abundance of caution, in four areas, our computer store sales, advertising income, small amount of farm income from contributed property, and a small amount of computer center use by an off-campus user. Thus far, we have not had a tax to pay on this. The net operating loss carried forward has been available to prevent the application of tax on these four items.

If the theory of the current unrelated business tax is correct, as I believe that it is, there is the question of the efficacy of its application, administration, and enforcement. I should note that at Vanderbilt, we were audited by the Internal Revenue Service 3 years ago and were not challenged on our reporting. But if these hearings or the data collection effort being commenced by the Internal Revenue Service disclose unintended results, abuses, or problems of enforcement, these should be addressed. The underlying principles of sections 511, 512, 513, and 514 are sound and should be preserved, however, including the relatedness test and the existing exclusions for dividends, interests, royalties, rents, research income, and convenience services. Thank you for the opportunity to present testimony.

[The statement of Jeff Carr follows:]

Statement of Vice Chancellor Jeff Carr,
Vanderbilt University

Press Release #25 of the Committee on Ways and Means of September 26, 1986 and the Honorable J. J. Pickle's announcement of May 14, 1987 both reflected interest in a review of the unrelated business income tax provisions, with particular attention to the federal tax treatment of "commercial and other income producing activities" of tax-exempt Section 501 organizations. Congressman Pickle's statement recognized the importance both to tax-exempt organizations and for-profit businesses of the hearings on this subject that have now been scheduled by the Subcommittee on Oversight. I am pleased to offer these comments on behalf of Vanderbilt University.

We apologize for the brevity of these written comments. They have been prepared in accordance with the deadline for the submission of comments established by the Subcommittee and there are a number of additional points and discussion that the deadline has precluded us from including. Time permitting, we will address some of these additional points in oral testimony or in a follow-up written submission.

The economic structure in the United States is generally viewed as being divisible into not-for-profit and for-profit sectors. Both sectors serve the nation well. Both compare favorably with other nations. And while there is growing concern about the international economic competitiveness of the United States, much of the optimism for enhanced future competitiveness rests on the undisputed past and present competitiveness of the not-for-profit teaching, research and service efforts of public and private higher education in the United States. As Chancellor Joe B. Wyatt of Vanderbilt University recently testified before a Subcommittee of the House Banking, Finance and Urban Affairs Committee,

> . . . the quality of the American education system directly influences the quality and competitiveness of U.S. industrial leaders and workers. Most of the new technology which forms the basis for improved industry and productivity in America derives from the research enterprise based in American universities. The quality of this research enterprise and the ability of U.S. industry to transfer technology developed in university laboratories to competitive American products are absolutely key elements for our future competitiveness. Statement Before the Subcommittee On Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs, March 10, 1987.

The distinction between the not-for-profit and for-profit sectors has never been, nor should it be expected to become, an impenetrable wall. Within the not-for-profit sector, there are activities that could profitably compete in the for-profit sector. Within the for-profit sector, there are activities motivated by a commitment to the public good in addition to those intended for private gain.

Current tax policy recognizes and equitably provides tax treatment for these crossover activities in each sector. The unrelated business income tax provisions require the reporting and the payment of federal income tax for the crossover activities of the not-for-profit sector; the charitable contribution provisions provide for relief from taxation for the crossover, public good activities of the for-profit sector.

There will be competition of varying degrees and varying kinds between the two sectors. Depending on the perspective from each sector, which can be expected to differ, the competition may be argued to be either "fair" or "unfair." The for-profit sector will express concern about whether tax exemption and, in some cases, lower costs for capital, give the not-for-profit sector an economic advantage. Current tax policy that offers the for-profit sector particular opportunities in competing for human resources with compensation packages based on preferential tax treatment concerns the not-for-profit sector. In addition, the increased interest on the part of the for-profit sector in identifying and moving into those areas in the not-for-profit sector that offer the potential for profit causes further concern. In recent years, we have seen a particular illustration of this latter concern in the health care field with proprietary organizations engaging in the delivery of health care services, not in the comprehensive way expected of the not-for-profit sector, but concentrating instead on health care services that can be made to be profitable by the exclusion of services inherently unprofitable.

Although these kinds of competitive forces can be expected to generate complaints on occasion, they contribute far more that is beneficial than prejudicial to the economic strength of the United States.

Consideration of changes in current tax policy as it applies to the crossover activities of the for-profit and not-for-profit sectors must take into account two important considerations; one is a certainty and the other is predictable.

First, the central distinction between the tax policies that are applied to the not-for-profit and for-profit sectors lies in the private inurement concept applicable to 501(c)(3) organizations such as Vanderbilt. No organization can be exempt from tax under Section 501(c)(3) where there is an inurement of net earnings to private individuals. Thus, for an organization to be exempt from federal income tax, any and all excess of revenue over expense must be utilized for the tax-exempt services rendered by the organization.

On the other hand, the inherent characteristic of for-profit organizations is the inurement of profit to private individuals.

The importance of the differing tax policy between the two sectors is that Section 501 exemption requirements, in and of themselves, establish the principle that insures that any excess of revenue over expense in the not-for-profit sector, whether taxed by the unrelated business income provisions or not, inures to the public good rather than private gain.

The second important consideration is that it is predictable that any extension of the application of the current unrelated business income tax will generate little if any additional tax revenue. Colleges and universities especially, and I expect that this is true as well for other Section 501 organizations, tend not to account for the expenses of their activities with the same detail and methodology utilized in the taxable, for-profit sector. A particular difference is in the accounting for depreciation; this is an expense item typically not shown on the operating statements of colleges and universities. The point is that because of differences in accounting practices some activities within colleges and universities may give a superficial impression of "profitability," but with the application of accounting principles consistent with those utilized in the for-profit sector these activities would not produce a profit as defined for federal income tax purposes.

Furthermore, in those instances where an activity in a not-for-profit sector might, nonetheless, result in a taxable profit under an expanded unrelated business income tax, the application of that tax could well have the effect of causing the abandonment of the activity thus resulting in no additional taxes but a decrease in services for the public good provided by the not-for-profit sector.

A particular illustration of the crossover activities of the not-for-profit and for-profit sectors lies in collaborative efforts between not-for-profit and for-profit organizations. These collaborative efforts frequently are creative in concept and highly effective in the contributions that they make. Current tax policy treats these collaborative arrangements fairly and appropriately, taxing the for-profit partner as it would otherwise be taxed, taxing the not-for-profit partner if the relatedness test of the activity cannot be met, and not taxing the not-for-profit partner for those activities that meet the relatedness test and thus would not be taxed if carried on independently by the not-for-profit partner.

This current tax policy allows the coming together for the public good of the different strengths and contributions of organizations from each sector. A particular illustration may be helpful to the members of the Subcommittee. Vanderbilt University has a strong School of Medicine with a full range of teaching, research, and clinical treatment programs, including a Department of Psychiatry. With new leadership and new faculty, the Department of Psychiatry in recent years has moved upward in excellence and in the reach of its research programs. Four years ago the Department of Psychiatry recognized the need and set the objective of providing additional in-patient beds necessary to compliment its teaching, research and clinical treatment programs. The particular area of need was a larger patient base for adolescent psychiatric patients. This need is caused by the growing national problem of the spiraling growth of chemical dependency and other psychiatric needs among our nation's young people.

The definition of this important national need, and the fact that it would be an insurmountable impediment, if unmet, to the future enhancement of the Department of Psychiatry, led to a search for any and all opportunities to meet the need.

We realized that Vanderbilt had the land and the professional faculty talent to support an additional facility, but not the capital. Learning of this need, two for-profit organizations approached Vanderbilt with proposals. A collaborative effort with Hospital Corporation of America (HCA) was developed under which an 88-bed Child and Adolescent Psychiatric Hospital would be built on

Vanderbilt land, professionally staffed with Vanderbilt faculty, financed by HCA capital, and managed by HCA.

Before proceeding, rulings were sought from the Internal Revenue Service and those rulings determined that the collaborative effort was consistent with and related to Vanderbilt's exempt purposes, and therefore would neither jeopardize Vanderbilt's tax exemption nor result in unrelated business income. HCA's share in any excess of revenue over expenses would, of course, be taxed.

Of particular importance is the point that this Child and Adolescent Psychiatric Hospital would not and could not have been built and operated without the unique contributions of both Vanderbilt and HCA. It is a collaboration that has resulted in increased availability of needed health services, and has made possible an enhanced research effort in Vanderbilt's Department of Psychiatry. Moreover, its work deals directly with one of the most serious and expansive problems in our society: the drug dependency and psychological problems of children and adolescents. If it in the future generates an excess of revenue over expenses, the resulting tax that otherwise would not have been generated will be paid by HCA.

This particular illustration is a case in which current tax policy serves equally well the interests of the not-for-profit sector, the for-profit sector, and of the government in the future generation of tax revenue. Collaborations of this nature must be encouraged and not discouraged through a change in tax policy.

In conclusion, I urge the Subcommittee on Oversight to proceed deliberately and with as much data as possible to evaluate the appropriateness and effectiveness of current tax policy in the unrelated business income tax area. We understand that the Internal Revenue Service is engaged in a data collection effort, and the results of that effort along with other data should be considered by the Subcommittee on Oversight.

I believe that it is likely that a full collection and analysis of data will confirm the efficacy of current tax policy, but whether that turns out to be the case or not it would be premature and unwise to make changes without that data and analysis.

Thank you for the opportunity to present our views.

Chairman Pickle. Thank you, Mr. Carr. Mr. Carr, since you have just finished your testimony, I noticed that you have just stated that Vanderbilt University has entered into a joint venture arrangement with the Hospital Corp. of America. I want to ask you, that is, Vanderbilt University, divide revenue generated from this joint venture, or how do you allocate expenses in this joint venture between Vanderbilt and HCA?

Mr. Carr. This is a partnership. A wholly owned, not-for-profit subsidiary of Vanderbilt is a general partner, a coequal managing general partner with a wholly owned, for-profit subsidiary of HCA, which is the other coequal managing general partner. In addition, Vanderbilt University is a limited partner by reason of its contribution of a 50-year land lease to the partnership. At present, this facility is not operating at a profit. If it does generate an excess of revenue over expenses, that revenue will be allocated first as a preferred return on investment to each party, Vanderbilt and HCA, and then divided equally after that preferred return on investment.

Under the terms of the partnership, losses are allocated 99 percent to HCA.

Chairman Pickle. Losses 99 percent to HCA?

Mr. Carr. In any year in which there are losses.

Chairman Pickle. Does either Vanderbilt University or the Hospital Corp. of America end up with any tax liability?

Mr. Carr. Vanderbilt would not by reason of the Internal Revenue Service ruling that I mentioned. I cannot speak for HCA.

Chairman Pickle. Let me say to this panel. This panel has been a group representing nonprofit universities and we appreciate your testimony. Each of us now are going to be limited in the questions we can ask. I want to say to you first, Dr. DiBiaggio, we appreciate it because you represent a large group of these organizations. On Monday of this week, Treasury Department had suggested that we might eliminate the exemption from UBIT for "the convenience of revenues" of tax-exempt organizations.

Mr. DiBiaggio. Yes, sir.

Chairman Pickle. And just allow the "relatedness" test to determine which of these activities would be taxed and which would not be taxed. I assume that you would oppose the elimination of the exemption, as has been recommended by Treasury. And incidentally, I want to commend Treasury again for giving us something positive ~~to work on~~ by way of recommendations. If you would oppose Treasury's position, could you give us your position and explain why you would oppose Treasury's position?

Mr. DiBiaggio. Well, only in part, and it again goes back to the definition of what are convenience items. I mean, if convenience items refer to such things as soap and toothpaste and such things that would be available in our bookstores or another facility on the campus, those would seem to be necessities. In many instances, such as at Notre Dame, when an institution is somewhat isolated from a large urban area, it is absolutely mandatory that they be made available to students through some mechanism and they do it through the university. I think the important thing is that each instance should be considered individually. For instance, I see no reason that bookstores should be selling stereos or cameras without paying tax on the sale of those items. That is perfectly legitimate.

That is quite different than those items which are needed for day-to-day functions. So indeed, only in that regard would I disagree.

Chairman PICKLE. Are you saying that campus bookstores selling cameras or other things, should pay a tax?

Mr. DIBIAGGIO. Yes and there are not many instances, I think, of that really occurring. We certainly do not sell cameras and stereos and such things, but where they do occur, and where there are abuses or where taxes are not being paid, that issue should be addressed.

Chairman PICKLE. Mr. Mason has outlined several areas where the University of Notre Dame is engaging in these activities and mentioned six or seven different categories where they are paying the UBIT, concerts, Ice Capades, bookstores, cemetery, computers, faculty golf course, and so forth. Do you think that is typical of most universities?

Mr. MASON. I think, like what was just stated, one has to look at each situation to some extent, given the environment. Our situation would be different than Michigan State; that is to say, we are a rural university. It is very difficult for our students to get to a shopping mall and we do not allow them to have cars in their first and second years, some of the things that might be construed to be convenient, we would construe to be mandatory. The other thing, as I mentioned, is that part of our community responsibility as a university requires us, and we go along with it freely, to use our facilities where there are not other comparable facilities available even though that results in unrelated business income.

We helped the city of South Bend construct and finance, through fundraising, the Century Center and that is where they now hold auto shows and boat shows. We were able to get that off our campus by helping them develop those kind of facilities. But right now, there is no facility within 75 miles that can house the Ice Capades or some of the concerts and we realized, in our discussions with the IRS, that those are unrelated. It would be almost impossible to think of a situation where a stereo would be related. On a camera, if one's dealing with a university that has a number of courses in industrial design and cameras are required, the bookstore sells those specific cameras to meet that course. They become textbooks or like computers, they are intellectually related.

Chairman PICKLE. Mr. Mason, the point I am trying to make is that you listed several of the activities that Notre Dame is involved in and that you were paying UBIT on and that you accepted that.

Mr. MASON. Yes, sir.

Chairman PICKLE. On the other hand, Michigan State is doing a lot of these things and is not paying UBIT.

Mr. MASON. Well, no, I said we are paying it.

Chairman PICKLE. You make the distinction that you are rural and this is an urban university, at least that was the thing I thought.

Mr. DIBIAGGIO. No, sir. I said we were paying tax on those. We did file a 990-T. We do pay taxes on many of our activities. We have been through audit. Some items were excluded by IRS.

Chairman PICKLE. All right.

Mr. DiBiaggio. It is somewhere included, interestingly, many of those that were excluded were those that we showed a loss on, those that were included in the profits.

Chairman Pickle. Let me ask you. I noticed on the list of groups that you represent, one was the Association of Jesuit Colleges and Universities.

Mr. DiBiaggio. Yes.

Chairman Pickle. Is Loyola University in New Orleans one of the members of your association?

Mr. DiBiaggio. Of the Jesuit Association, yes.

Chairman Pickle. Well, are you familiar with their commercial television and radio stations?

Mr. DiBiaggio. No, sir, I am not.

Chairman Pickle. Do they pay UBIT?

Mr. DiBiaggio. Sir, I do not know but we can certainly get a response to that question for you.

Chairman Pickle. You do not have any idea whether they pay any tax?

Mr. DiBiaggio. No, sir, I do not. And again, that is an instance where an individual institution has to be evaluated on its own basis and we are not familiar with what is happening within the 3,000 colleges and universities in this country on an individual basis.

Chairman Pickle. Well, I am surprised that you are here speaking for them and you would not have an idea whether they pay any tax or not on a television operation. Mr. Schulze?

Mr. DiBiaggio. In fact, I understand that you have someone due to testify on your next panel from that institution.

Chairman Pickle. Well, we had one scheduled and I think it has been scheduled. I am trying to get some information for the record.

Mr. DiBiaggio. Well, sir, we will certainly, as you asked before, Mr. Chairman, be delighted to provide you with the kind of information you require and additional information, if necessary.

Mr. Schulze. Thank you, Mr. Chairman. I would like to thank the panel for their testimony. As perhaps you are aware, the majority of the complaints which we have received on this issue are probably related to college and university activities. If we are going to make any changes, your testimony will be very important. It seems to me that one of the ways we can be more definitive in a cloudy area is by better reporting. It is for us to have more definitive information. Do any of you have any suggestions on how the form 990 could be improved so that we could make better decisions from the data received?

Mr. Mason. I think the National Association of College and University Business Officers, through those——

Mr. Schulze. Mr. Mason, do you want to get a little closer to that microphone?

Mr. Mason. The Business Officers group, through their taxation committee, I believe, has had working sessions with the Internal Revenue Service on that issue. I think they have reached some agreement on how better disclosure, I am not familiar with the detail. As I look at our 990-T here in front of me, certainly all the issues I mentioned to you are laid out in detail. Other activities that relate to the 990 that might raise additional questions are also set forth here in addition to the items I mentioned. For instance, Mr. Chairman asked the question about Loyola. I am not familiar with their TV station. I am led to believe that they have a special tax law that applies to them. We, at the University of Notre Dame, are also involved in a TV station.

It is a separately incorporated, tax-paying, wholly owned subsidiary. To the extent that any dividends or interest move from the station to the University, they show up and do show up on this tax return. I think that the situation right now with the Internal Revenue and the Business Officers working together, there is a cooperative effort to provide as much information as the IRS thinks is necessary.

Mr. SCHULZE. From the point of view of the colleges and universities of the country, do you think there is the possibility that some are engaged in unrelated businesses and are not aware of the obligation to pay such taxes?

Mr. MASON. Yes and I do not think there is anybody on this panel that would disagree with the concept that if any university is engaged in an activity unrelated and determined to be so by the Internal Revenue Service, they should pay tax and we would support that. I think that our issue here is not one of the facts. We would make some distinction between universities, but we certainly believe that we are in the education business and we want to stay there as a general principle and activities that are unrelated, should pay tax.

Mr. SCHULZE. Mr. Bruce, did you have something to add?

Mr. BRUCE. I would say, Congressman, that it is entirely possible that some of the smaller colleges and universities might not be aware fully of some of the activities. One example that we had that we did pay, file a 990–T, was when we had the Philadelphia Eagles training at our campus. And obviously, that was an unrelated business and we did file on that. But that is an area that one knew immediately. I am sure there are a lot of gray areas that probably more communication is needed.

Chairman PICKLE. Would you yield?

Mr. SCHULZE. Sure.

Chairman PICKLE. Do you represent Widener University?

Mr. BRUCE. Yes, sir.

Chairman PICKLE. Does Widener University operate a Sheraton Hotel?

Mr. BRUCE. Yes, sir.

Chairman PICKLE. Is that a taxable subsidiary?

Mr. BRUCE. Yes it is. It is a Delaware corporation that is subject to all the taxes that any other business entity.

Chairman PICKLE. But you do operate a Sheraton Hotel? I want all the panel later to give me information about whether each of you operate a taxable subsidiary. Do you all have taxable subsidiaries? Well, for you witnesses and others, submit to us any instances where you do have taxable subsidiaries. And, Mr. Mason, before I conclude, I want to yield back the time here. In your case at Notre Dame, is income from the college athletic events or the income from broadcasting rights, considered as taxable income? Is it related or unrelated to the university's tax-exempt purpose.

Mr. Mason. No. That has been determined by the Internal Revenue Service to be related. If you go back to the initial thrust of the Internal Revenue Service about 10 years ago, I think the original issue which confronted universities on the issue of unrelated business income, was the bowl revenue, TV revenue specifically, Texas, Southern Methodist. The issue was resolved in favor of related income to the universities. The athletic department in our situation, on our books, looks just like the bookstore, the Morris Inn, or any other auxiliary activity. That is to say, their budgets and their revenue are part of the central administration and the central system.

Chairman Pickle. Thank you. Mr. Schulze?

Mr. Schulze. Certainly, Mr. Chairman. I would like, for a minute, to turn to research, testing, laboratories, that area of endeavor. I have, in my files, several case histories and lists where there have been head-to-head competition between university laboratories and private sector laboratories. The examples which are sent to us, are where the university prevailed in these head-to-head contests. Do you have any opinion for a general rule or how we should view this kind of relationship? Where the line could and should be drawn? Granted it is a gray area. I also will grant that almost anything a university could do in almost any field of endeavor, could be made to look educational, and so our problem is to try to draw these lines. I would like to hear your thoughts on testing and research.

Mr. DiBiaggio. Well, in essence, the other argument could be made anything we do could be shown to be profit oriented as well or competitive. The fact of the matter is that many of the activities in which we engage have a direct relationship to our research activities and to our service functions. Many of them began many years ago, of course, when we were the only institutions that provided those services. Many of them are part of our mandate. In our instance, as a land grant university to provide certain kinds of testing services to the agricultural community in the state of Michigan. And, indeed, we engaged in those activities before they were available from any other vendors.

Mr. Schulze. What do you say, doctor, that most of the complaints are coming from your former students. I mean, you have been very successful in creating this great body of people who want to carry this work on and want to do it in competition with you.

Mr. DiBiaggio. Yes, sir. But I think that if a test is drawn, and the institution is compelled to shown the relationship, the very direct relationship to the educational and research programs, and indeed, that cannot be shown, then indeed, those items should be taxable. But, for instance, we provide radiology services in the state of Michigan to the prison system. We read radiographs. We did that long before anybody else was interested in doing that. We do not have a teaching hospital, per se, we have community based hospitals as part of our medical complex. We did that on a competitive bid basis. It is used for teaching purposes, for research purposes, as well as providing a service to the State of Michigan.

So, in essence, those are difficult issues and those issues must be carefully, carefully investigated, not based on any anecdotal kind of evidence, but rather on a case-by-case basis to determine if, indeed, we are doing something which falls within the purview of our mission.

Mr. SCHULZE. Doctor, that is a pretty vague mandate for us to give to the IRS. I am not going to try to pin you down right now but let me just say, if you or your groups have any more definitive suggestions, we would be happy to have them. We are probably going to come up with some and so that you probably should have some input into that process. Whether it can be done on a percentage basis, or if there is some other yardstick, some other formula which could be used, I am concerned about getting in too rigid a formula. But if there are any suggestions you have or that any other panelists have in this area, I would be happy to have them. Thank you, Mr. Chairman.

Chairman PICKLE. Thank you. Mr. Anthony?

Mr. ANTHONY. Thank you, Mr. Chairman. I have a question to the panel as a whole. Have you received any complaints within the last 12 months from any small business person residing within your community complaining of competition with any of the activities that your universities or colleges pursue? Mr. Altman?

Mr. ALTMAN. I have received one in the last 12 months that has to do with our campus bowling alley. Our campus bowling alley is used primarily for physical education classes. Two-thirds of its budget comes from tuition charges. In the evenings, we have had leagues that have been sponsored there and the owner of the only bowling alley in Kingsville, complained that we were unfairly competing with his establishment because some nonuniversity people were playing in the leagues in the evenings. We reviewed our policy and our practice on this matter and, in fact, found that to be the case. We have changed our policy. We have revised our conditions to restrict league play to university students, faculty and staff. That disagreement was resolved quickly and amicably and has no longer served to be a problem.

Mr. ANTHONY. I take it, then, that——

Mr. DIBIAGGIO. We have all had them. Let me give you an example. Our tennis facility, which is a brand new facility, is used for intercollegiate tennis and for the teaching of students. But during the times when it is not used for that purpose, it is used by faculty and community members. We have determined that we have established fees for that usage higher than those charged by local racket clubs so that we were not in direct competition in costs and that we would certainly pay tax, for those individuals who are not directly related to the institution, that is, faculty, staff or students, who use the facilities.

Mr. ANTHONY. So in those cases, you have to keep a fairly careful set of books in order to show the difference between the two?

Mr. DIBIAGGIO. Yes, sir and we do.

Mr. ANTHONY. Which argues against a little bit of what Mr. Carr said in his testimony in that he indicated that universities did not keep those kind of records and maybe if the laws were changed, they would be forced to have to create better bookkeeping in order to differentiate between the two.

Mr. DIBIAGGIO. The question is does that require a change in the law or simply regulation to spell it out in administrative structures.

Mr. **Anthony**. A second question to the panel as a whole. Have you had an opportunity to review the Treasury Department's UBIT recommendations? Have any of you had an opportunity to see what the Treasury has recommended to this Subcommittee?

Mr. **DiBiaggio**. Yes, just very briefly.

Chairman **Pickle**. Have all of you seen the Treasury's recommendations?

Mr. **Anthony**. I would make a request, Mr. Chairman, that each of the witnesses submit a written response back on Treasury's recommendations for our study.

[The following was subsequently received:]

POWELL, GOLDSTEIN, FRAZER & MURPHY
ATTORNEYS AT LAW

SUITE 800
900 CIRCLE 75 PARKWAY
ATLANTA, GEORGIA 30339
404 951-5800

SUITE 1050
400 PERIMETER CENTER TERRACE
ATLANTA, GEORGIA 30346
404 396-2800

SIXTH FLOOR
1001 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20004
202 347-0066
TELEX 650 2510 330
TELECOPIER 202 624-7222

ELEVENTH FLOOR
THE CITIZENS & SOUTHERN NATIONAL BANK BUILDING
35 BROAD STREET, N.W.
ATLANTA, GEORGIA 30335
404 572-6600

July 27, 1987

The Honorable J. J. Pickle
United States House of Representatives
242 Cannon House Office Building
Washington, DC 20515

Dear Mr. Chairman:

In response to the request by the Subcommittee on Oversight of the House Ways and Means Committee for additional information which bears on the hearings held on the unrelated business income tax imposed on tax-exempt institutions, I am enclosing the results of an unofficial survey of the income-producing activities of 195 colleges and universities which is now complete through July 1, 1987. I represent the American Council on Education, the Association of American Universities and the National Association of State Universities and Land-Grant Colleges who were represented at the recent UBIT hearings by Dr. John DiBiaggio, the President of Michigan State University. This data has already been submitted to the staff of your Oversight Subcommittee by the National Association of College and University Business Officers ("NACUBO") which prepared and conducted the survey.

The questionnaire was originally mailed to 481 institutions chosen at random from 2,641 higher education institutions. Thus, the 195 respondents comprise only 40 percent of the survey sample and 7.5 percent of the higher education community. We do not purport this to be a scientifically valid survey; but, nevertheless, want you and members of the Subcommittee to have the information. The enclosed tables sort the sampled institutions according to type of school (2-year/4-year/ university), the type of organization (public/independent), and its geographic region. As the tables indicate, the highest response rate (11.5 percent) came from public universities; and the lowest response rates came from private two-year colleges (3.3 percent) and public two-year colleges (6.9 percent). The response rates for the remaining institution categories were approximately 8.5 percent. Given the large element of self-selection among the respondents, we believe that it is inappropriate to generalize from these responses; however, this is the best survey data which exists within the higher education community on this issue.

The survey asked about 22 activities or auxiliary services including those commonly mentioned by the small business community in its criticisms of colleges and universities. The survey responses also included activities which are provided by private, taxable enterprises on college and university campuses -- i.e. contracted out. For example, in the case of one hotly contested issue, travel services, 15 schools indicated that they offer non-institutional travel services; however, 9 of those 15 schools (60 percent) contracted out those services to a private business. Accordingly, only 6 of 195 colleges and universities directly provide non-institutional travel services.

On the other hand, many schools which do provide auxiliary services directly limit access to those services to the campus community. For example, while 152 schools provided copying and duplicating for the benefit of the institutional community, only 29 schools provided copying and duplicating services to the general public and two of those 29 contracted out. In another area raised by the small business community, computer sales, 76 institutions provided computer sales to the campus community. But only 9 schools made such sales to the general public, of which one contracted out.

In many other areas the survey would make it difficult to draw valid conclusions. For example, 60 schools reported engaging in "analytical testing." However, the survey does not indicate the nature of such testing. For example, analytical soil testing is conducted by many land grant institutions by order of their state legislatures or pursuant to a mandate contained in their charters. Other colleges and universities conduct analytical testing to compile data for research projects or to aid in student training. Presumably, these institutions would have responded affirmatively when asked if they conduct "analytical testing".

Similarly, the questions directed at the rental of various university facilities do not indicate the nature of the use. For example, many schools will rent conference facilities and dormitory rooms to other non-profit institutions at cost in order to keep the facilities operational and the staff employed when the school is not in session. Such rentals are not competitive with any private business. In addition, many colleges and universities rent athletic facilities to local high schools to encourage and improve their athletic training. Finally, many colleges and universities believe that it is part of their mission to provide educational outreach to the local community by making their facilities available for concert and lecture programs. Accordingly, many of the 139 schools which sponsored concerts for the general public were acting pursuant to the educational mission of the school.

The survey attempted to indicate when colleges and universities began offering specific services. Predictably, those services which the majority of the schools began offering after 1975 consist primarily of activities or services directly related to or resulting from new technologies--for example, computer sales, sales of computer time, radio and television broadcasting and rental of educational video tapes.

The survey also collected information on whether the responding institutions reported unrelated business income on the form 990T, on whether the respondents had been audited by the IRS and on the results of those audits. In 1986, 38 of the responding schools (20 percent) filed the form 990T, and 37 schools reported having been audited for unrelated business income. Of those audited, 14 schools had not filed a form 990T. The respondents were asked to provide detailed information with respect to the outcome of these audits, and their statements are attached as an appendix to this survey. In summary, only 3 schools reported that the IRS had made exceptions or disallowances; 3 audits are still open; 3 schools reported being required to file the Form 990T, and 24 reported either that no problems were found or that all issues were resolved in favor of the institution. Moreover, those schools which were required to file the Form 990T did not owe any net tax on their unrelated activities. Accordingly, to aid our institutions in complying with current law, we have separately recommended that every school with an enrollment in excess of 1,000 students be required to file the Form 990T automatically.

Finally, the respondents were asked to list any income-producing activities not itemized in the survey and to describe any legal actions filed against the institution with respect to any activity. These responses include activities contracted out and activities conducted within the institutions' endowments. Only 19 schools conducted any non-itemized activities, and that list, together with the type of institution responding, appears as an attachment to the survey. Only 5 of the 195 respondents reported having legal actions filed against them with respect to auxiliary services. Two of these 5 reported actions dating from the 1960's: the first, concerning state sales taxes on its bookstore sales, and the second, concerning separate actions to enjoin the construction of hotel and parking facilities. The remaining three schools were cited for (1) bookstore sales, (2) travel services and (3) aquatic and copy centers. One additional school has been threatened with legal action for computer sales by its bookstore.

In general, to the extent that generalizations can be made, we believe that this survey indicates that colleges and universities generally do not conduct business activities which are unrelated to their educational, research and public service missions. Moreover, the fact that only 3 of 37 schools audited by the Internal Revenue Service were required to pay additional UBIT demonstrates, we believe, a very high compliance rate with the UBIT and indicates that colleges and universities are generally abiding by current law.

We will shortly present to the Subcommittee comprehensive suggestions for improving compliance with the UBIT based on the proposals made to the Oversight Subcommittee by the Treasury Department on June 22, 1987. In addition, the undersigned organizations will undertake to publicize any clarifications of existing law which are made by IRS or Treasury and will seek to ensure that the higher education community complies fully and fairly with the law.

We looking forward to working further with the Subcommittee during the coming months in connection with its review of UBIT.

Very truly yours,

Stuart E. Eizenstat
American Council on Education
Association of American Universities
National Association of State
Universities and Land-Grant
Colleges

SEE/td

cc Barbara A. Pate
Russlyn Guritz
Melvin Thomas

POWELL, GOLDSTEIN, FRAZER & MURPHY
ATTORNEYS AT LAW

SUITE 800
900 CIRCLE 75 PARKWAY
ATLANTA, GEORGIA 30339
404 951-5800

SUITE 1050
400 PERIMETER CENTER TERRACE
ATLANTA, GEORGIA 30346
404 399-1800

SIXTH FLOOR
1001 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20004
202 347-0066
TELEX 650 2510 330
TELECOPIER 202 624-7222

ELEVENTH FLOOR
THE CITIZENS & SOUTHERN NATIONAL BANK BUILDING
35 BROAD STREET, N. W.
ATLANTA, GEORGIA 30335
404 572-6600

August 3, 1987

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
United States House of Representatives
242 Cannon House Office Building
Washington, DC 20515

Dear Mr. Chairman:

We enclose herewith the response of the American Council on Education, the Association of American Universities, the National Association of State Universities and Land-Grant Colleges, and the witnesses who testified before the Oversight Subcommittee on June 25, 1987, to the recommendations of the Department of Treasury on the unrelated business income tax.

This is in response to your request for our views on the Treasury suggestions.

We trust they will be useful to you and to the Subcommittee.

Sincerely,

Stu Eizenstat

Stuart Eizenstat

SE/mtd

AMERICAN COUNCIL ON EDUCATION
Division of Governmental Relations

July 31, 1987

Congressman J. J. Pickle
Chairman, Oversight Subcommittee
Committee on Ways and Means
United States House of Representatives
242 Cannon House Office Building
Washington, D.C. 20515

Re: Unrelated Business Income Tax Hearings:
Response to Treasury Recommendations

Dear Mr. Chairman:

We appreciated the opportunity for several of our member institutions to testify before the Oversight Subcommittee during its June hearings on the unrelated business income tax. As you know, during the course of those hearings questions were posed to the representatives of higher education, as well as to other witnesses. We have tried over the past several weeks to address those questions fully and fairly in discussions within our membership. These comments are accordingly being submitted on behalf of President John DiBiaggio of Michigan State University, President Steven Altman of Texas A & I University, President Robert Bruce of Widener College, Thomas Mason, Vice President for Business at Notre Dame University, Jeffrey Carr, Vice Chancellor for Student Affairs and General Counsel of Vanderbilt University, and the higher education associations listed on the cover sheet of our testimony delivered on June 25, 1987.

Our institutions acknowledge the seriousness of the concerns voiced by members of the Subcommittee. We believe that the law in this area can be improved, although we believe that the process should be a deliberate and cautious one. We are anxious, therefore, to provide whatever assistance we can to assure that changes are directed at real abuses, and will result in real improvements. We also want to be sure that elements of present law that support

One Dupont Circle, Washington, D.C. 20036-1193 (202) 939-9355

significant educational purposes are not inadvertently lost.

We have given particular attention to the recommendations and suggestions set forth in the statement of O. Donaldson Chapoton, Deputy Assistant Treasury Secretary for Tax Policy, before the Oversight Subcommittee on June 22, 1987. We believe that the Treasury's suggestions are responsible and constructive, and that they can serve as a sound basis for improvements in the operation of the unrelated business income tax. A few of these revisions, as the Treasury statement indicates, can only be accomplished by legislation. A few, we believe, may be better handled through the issuance of regulations or rulings. Our reactions to the Treasury testimony are set forth below.

The Treasury statement recognized that the basic structure of the tax, and specifically the "substantially related" standard, is appropriate in determining when activities of exempt organizations should be subject to Federal income tax. It also concluded that the exemption for investment income of charitable and educational organizations, which is critical to many of our institutions, must be preserved. The Treasury statement acknowledged the vital significance of research to educational purposes and to our national economy, and the need for reasonable incentives to promote research efforts. In these and in other respects, the Treasury emphasized the importance of preserving the key elements of present law, while addressing isolated abuses and deficiencies by specific statutory or administrative change.

The Substantially Related Standard. The Treasury statement concludes that the "substantially related" standard used in determining which activities of charitable or educational organizations are exempt from Federal income tax has "conceptual merit". We agree. We believe that this standard can be interpreted so as to apply only to those activities which do in fact promote exempt purposes in some significant way. As we stated in our original submission, we believe that where an organization is deserving of tax-exempt status, its exemption should extend to the array of activities which contribute importantly to the accomplishment of its charitable or educational mission.

We do not know of any alternative standard that would satisfy the objectives and be consistent with the policies of the unrelated business income tax, without requiring factual determinations and judgments that would be at least as difficult as any required under present law. Certainly any standard involving "competitive" effects or "commercial" characteristics would contravene in the most basic way the long-standing policy of exempting activities which actually contribute importantly to the promotion of charitable or educational objectives, regardless of the current practices of the marketplace. At the same time, we believe that any standard requiring an analysis of commercial or competitive factors would be more subjective, would produce more controversy and less certainty, would be more subject to change with economic swings and cycles, and would be much more difficult to administer, than the present relatedness standard. We agree with the Treasury, therefore, that the relatedness standard should be preserved.

We also agree with the Treasury that compliance with the unrelated business income tax and administration of the relatedness standard would be improved by expanded disclosure requirements. We would support changes to the Federal reporting and return Forms 990 and 990-T for this purpose. Specifically, we would support the addition of a new schedule to the Form 990, to be completed by all organizations with non-donated revenues in excess of a specified amount, whether or not such organizations are otherwise required to file Form 990. Such a schedule could require specific description of those revenue-generating activities as to which additional data is needed by the Congress or the Internal Revenue Service. Requiring such a schedule would not only provide the Internal Revenue Service with the information necessary for comprehensive data collection and an enhanced audit program, but would ensure that tax-exempt organizations have occasion to focus upon the tax treatment of their various activities.

Passive Income. The Treasury acknowledges the importance of investment income to exempt organizations, and supports preservation of the unrelated business income tax exemption for such income in the case of public charities such as colleges and universities. We agree with this position.

A tax on the investment income of colleges and universities would be a radical departure from established tax policies and would, we believe, constitute a dangerous precedent. Imposition of a tax on investment or endowment income would limit the ability of colleges and universities to fill part of the gap resulting from reductions in federal funding for student aid and other programs. It would affect the quality of education generally, and it would affect students needing financial aid disproportionately. We therefore strongly endorse the Treasury statement to the Subcommittee supporting a continued exemption from the unrelated business income tax for the passive investment income of public charities, on the grounds that such income is used to support organizations that act for the public good, and that "the exemption for passive investment income may appropriately encourage exempt organizations to avoid deeper commercial involvements and the potential distractions and conflicts they present."

The Convenience Exception. The Treasury statement questions the need for the current exception from the unrelated business income tax for activities carried on for the convenience of students or similar groups. The Treasury agrees that operations such as dining halls and dormitories should be exempt from the tax, but suggests that the relatedness standard might allow such exemption.

We agree that many if not most of the activities currently conducted under the "convenience" umbrella could be defended under the relatedness standard. However, it was precisely to avoid the need to litigate the question of relatedness in such cases that Congress enacted the convenience exception. We believe that the exception serves a real function in this respect, and that its elimination would lead to a great deal of uncertainty for colleges and universities and a great deal of needless administrative effort for the Internal Revenue Service.

At the same time, the higher education community acknowledges that the convenience exception may have been relied upon in some cases to shield from the unrelated business income tax activities or transactions that do not contribute in an important way to the accomplishment of exempt purposes. We believe, for example, that the operation of travel agencies or the sale of items such as non-educational appliances and other durable goods may not qualify for exemption under the convenience exception.

We propose that the convenience exception be applied in such a way as to encompass only those activities that serve the administrative functions of the college or university, or that support the educational activities or the basic recurring personal needs and sustenance of students and other members of the university community.

The convenience exception applies to a variety of activities conducted by a wide range of exempt organizations. Even within the higher education community, it is important to keep in mind that the educational institutions that would be subject to such a provision include not only urban institutions but also rural campuses that are often miles away from the closest town, with a large population of students who lack ready access to any transportation. As the Internal Revenue Service has recognized, campus shops at such institutions must sell - not merely as a convenience but virtually as a necessity - a wider variety of items than their urban counterparts.

Because the convenience exception potentially applies to a considerable range of institutions and situations, we believe that it may be preferable to narrow its scope through the issuance of regulations. Such regulations could include not only a general rule or statement of the standard but also a series of examples designed to illustrate the practical application of the standard. The Internal Revenue Service has in fact already developed criteria, reflected in a series of General Counsel Memoranda but never published or announced, that could serve as the basis for more comprehensive regulations.

G.C.M. 35811 (May 7, 1974), for example, set out the legal basis for a proposed ruling (unfortunately never issued) on the application of the convenience exception to the sale of various items in campus book stores, both urban and rural. The memorandum suggested that the exemption should apply to the sale of items used in the conduct of educational programs; items with an ordinary useful life of one year or less; items of relatively low cost and recurrent demand; items that promote the institution by displaying its name or logo; or items not readily available from other sources in the immediate geographic area. Obviously these particular criteria would have to be modified in order to apply to exempt organizations generally. We believe that an approach of this kind, however, would eliminate many of the problems with the convenience exception, without creating new problems of interpretation under the relatedness standard.

Research. The Treasury statement suggests that the exception from the unrelated business income tax for research should identify the particular types of research activity that the nation wishes to encourage, and should include requirements to ensure that the public actually benefits from tax-exempt research. Recognizing the broad interests at stake, the Treasury encourages the participation of the scientific and academic communities in the development of any new standard for the exemption of research activities.

The unrelated business income tax now exempts both basic and applied research performed by colleges and universities, while taxing ordinary commercial or industrial activities. We strongly support the continued exemption for all basic and applied research performed by colleges and universities.

As we indicated in our original statement, university research (as opposed to testing) tends to be a source not of competition but of critical support to small businesses, as well as a matter of critical significance to our economy. Although we do not believe that research as such is an area of potential unfair competition, we would support in principle the adoption of a legal standard that would distinguish between research (both basic and applied) on the one hand, and commercial or industrial operations on the other. We concur absolutely in the Treasury's judgment that this issue has broad social and economic implications, and that the scientific and academic communities should be fully involved in the process of formulating such a critical definition.

Several of the witnesses who appeared before you complained of competition in various forms of testing, and we would support the inclusion in the statute or in Treasury regulations of a definition designed to distinguish between commercial testing and testing that is a valid component of the college or university function. We note in this regard that certain kinds of testing, as well as certain research and other public service activities, are actually included in the state legislative mandates of some of our institutions such as land grant colleges and state universities. These public service activities are deeply rooted in the traditions of many states, and have become integral to many local economies. We would hope that any change to the research exception, or indeed to any of the provisions of the unrelated business income tax, would take proper account of this important tradition.

Royalties. The Treasury Department proposes to narrow the royalty exception, so as to exclude from the royalty definition any amounts received for endorsements of commercial products or for other exploitations of institutional good will. Although such a change might affect a number of our colleges and universities, we would support it as a reasonable response to perceived abuses. We assume, of course, that any such change would be prospective, so as not to penalize established arrangements.

We urge the Subcommittee to give particular care, in any consideration of the royalty exception, to the important issue of university technology transfers. In our original statement we described the need for an active technology transfer program; the dependence of the business sector on technology transfers from universities; and the deliberate Congressional and governmental policy of encouraging technology transfers as a vital aspect of national technological progress. Congress made the decision in the Uniform Federal Patent Policy Act to transfer to universities the title to inventions made with government funding specifically to encourage universities to be active in identifying patentable ideas and to invest resources and energy in their development. Technology transfers are typically accomplished through a licensing or royalty arrangement, and because it is impractical to impose a large fixed-cost royalty on an untested product, the arrangements are best suited to a sharing of net profits.

We believe that you would find widespread support for a continued royalty exemption for technology transfer arrangements both among commercial firms in the research and technology industry, and among the Congressional and governmental committees and agencies which are concerned about our national technological standing. We would urge the Subcommittee to give this issue particular attention.

Allocation of Expenses. When a tax-exempt entity engages in an unrelated trade or business, current law provides that the income from such activity will be computed for Federal income tax purposes as if it were a taxable business. That standard, which is both fair and practical, serves the purpose of placing the exempt organization, as to its unrelated activities, on a par with taxable business.

The Treasury suggests two particular accounting changes: one (a reversal of the holding in a case involving Rensselaer Polytechnic Institute) that would require allocation of expenses based on theoretical potential use rather than actual use of facilities; and the other to limit the aggregate deductions available with respect to an unrelated business activity. We strongly object to both, and in particular we support the very thoughtful judicial opinion that resolved the dispute in the case of Rensselaer Polytechnic Institute. The rule that the Treasury suggests would not achieve parity with businesses (which are permitted to allocate expenses between activities on an actual basis) but instead would unfairly penalize exempt organizations which attempt to limit their costs by permitting external access to expensive equipment such as computer centers.

The Fragmentation Rule. The "fragmentation rule" of current law requires that any unrelated income-producing activity which is conducted in the course of a related exempt activity must nonetheless be reported as subject to tax. For example, under this rule items sold by a campus bookstore that do not support the education or serve the needs of members of the campus community would be identified and taxed, notwithstanding the fact that the bookstore itself is tax exempt. Compliance with this rule, as the Treasury statement notes, does impose a considerable administrative burden on educational institutions. Nonetheless, we support the continued operation of the fragmentation rule as an appropriate tool for the enforcement of the unrelated business income tax.

Taxable Subsidiaries. Under present law, payments of deductible items such as interest, royalties, rent, or annuities from a "controlled" subsidiary are taxed upon receipt by an exempt parent. The purpose of this rule is to prevent the tax-free flow of money from a subsidiary that carries on what should be taxable activities. The Treasury proposes that the control definition be expanded to include a 50 percent rather than an 80 percent ownership test; that the test be applied by reference to value as well as voting power; and that ownership attribution rules be enacted.

We believe that applying the control test to the value of the stock interest in a subsidiary (thus eliminating the present law option of avoiding "control" through creation of a second class of stock) and adding ownership attribution rules are reasonable measures to address what we agree has been a problem in this area. We support these changes, and we believe that they would be sufficient to eliminate the potential for abuse without changing the control standard from 80 percent to 50 percent. Nonetheless, if it is the opinion of the Treasury that a 50 percent control test is necessary, even with the other changes to the definition of control, we would not oppose adoption of such a test, provided that, consistent with usual legislative practice, all of these changes would be prospective only and would not disrupt existing arrangements.

In addition, the Treasury Department proposes aggregating the activities of taxable subsidiaries with the activities of an exempt parent for purposes of determining whether the parent's activities are primarily charitable. Where a taxable business is not only separately incorporated but also separately managed, we do not believe that there is any reason to treat such a business as if its activities were conducted directly by the exempt parent. However, in circumstances where officers and directors of the exempt parent actually manage the daily activities of a subsidiary, so that administrative resources of the exempt parent are indeed diverted to the daily operations of the taxable business, the Internal Revenue Service now requires aggregation, and we agree that in such cases it is appropriate.

Partnerships. The Treasury makes two proposals dealing with the participation of exempt organizations in joint ventures or partnerships. First, the Treasury suggests that because of the possibility that deductions and other tax benefits can be shifted from tax-exempt to taxable partners, the rules governing partnership allocations between tax-exempt and taxable entities should be revised. Second, the Treasury indicates concern about the use of partnerships or joint ventures to accomplish exempt purposes, and suggests that under certain circumstances the exempt organization's share of income from a partnership with a taxable partner might be subject to the unrelated business income tax.

The particular case that the Treasury cites as an example of the shifting of tax benefits is illustrative of a fairly common partnership situation in which the tax characteristics of the partners are at variance. This could happen because one of the partners is a tax-exempt organization, or an insurance company, or a bank, or an individual or entity with excess foreign tax credits - any situation in which the partners have different marginal tax rates. These tax-shifting opportunities are for the most part the result of more-than-economic depreciation deductions and other tax incentives enacted by the Congress. To the extent that there is a problem with these incentives, the role of tax-exempt organizations in such a problem is a relatively minor one.

We believe that any significant abuses in this area have been addressed by earlier legislative activity, and by the recently issued regulations under section 704 of the Internal Revenue Code. To the extent that any concerns remain, they should not, and really could not feasibly, be addressed solely in the context of tax-exempt organization arrangements.

The Treasury's second proposal in the partnership area includes partnerships or joint ventures to promote exempt purposes. Colleges and universities enter into such arrangements only when there is some valid reason to do so - some reason why the college or university cannot financially or practically pursue the exempt activity on its own. When a college or university does enter into a partnership or joint venture, it is subject under present law to strict tax rules and other rules that prohibit use of the institution's funds or resources to benefit individuals or other private interests, and that require the institution to ensure that taxable partners receive no greater share of partnership profits than is necessary to secure their participation in the venture.

The rules of present law in this respect are very clear, and we believe that for the most part they are accepted and observed. We agree with the Treasury's view that, if such rules are violated, imposition of tax rather than loss of exempt status is the appropriate remedy, and we would support such a change in the law. We do not agree, however, that the use of partnership arrangements is a subject of recurring abuse, and we would certainly not support any blanket disincentive to participation in partnerships for exempt purposes.

In conclusion, we welcome the opportunity to work with the Subcommittee and with the Treasury Department in formulating specific legislation and in developing regulations and rulings based on the positions taken in the Treasury's statement.

Yours truly,

Sheldon Elliot Steinbach

Sheldon Elliot Steinbach
Vice President and
General Counsel

POWELL, GOLDSTEIN, FRAZER & MURPHY
ATTORNEYS AT LAW

SIXTH FLOOR
1001 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D.C. 20004
202 347-0066
TELEX 650 2610 330
TELECOPIER 202 624-7222

SUITE 800
900 CIRCLE 75 PARKWAY
ATLANTA, GEORGIA 30339
404 951-5800

SUITE 1050
400 PERIMETER CENTER TERRACE
ATLANTA, GEORGIA 30346
404 399-2800

ELEVENTH FLOOR
THE CITIZENS & SOUTHERN NATIONAL BANK BUILDING
35 BROAD STREET, N. W.
ATLANTA, GEORGIA 30335
404 572-6600

August 3, 1987

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
United States House of Representatives
242 Cannon House Office Building
Washington, DC 20515

Dear Mr. Chairman:

We have recently sent to you and other members of the Subcommittee our analysis of the NACUBO survey, together with the survey itself, relating to the business activities of colleges and universities. Attached herewith is a memorandum summarizing a series of discussions we have held over the last several months, through July, with specific colleges and universities which will provide additional information for the Oversight Subcommittee regarding its work on the unrelated business income tax.

The universities mentioned in this memorandum with whom we have had discussions are the following: Purdue University, Texas A&M University, University of Michigan, University of Pennsylvania, University of Southern California, and George Mason University.

The American Council on Education, the Association of American Universities, and the National Association of State Universities and Land-Grant Colleges wish to continue to cooperate with you and with the Subcommittee to provide the information you desire.

Sincerely,

Stu Eizenstat
Stuart Eizenstat

SE/mtd

MEMORANDUM

RE: Summary of Discussions with a Cross-Section of Colleges and Universities on their Activities Related to UBIT

In preparation for the hearings by the Oversight Subcommittee of the House Ways and Means Committee, we have held discussions through July, 1987, with representatives of a cross-section of colleges, universities and community colleges to provide additional information to the Oversight Subcommittee of the House Ways and Means Committee on the history and current status of college and university business activities. This memorandum summarizes those discussions. The universities included in this report are Purdue University, Stanford University, Texas A&M University, The University of Michigan, The University of Pennsylvania, The University of Southern California, and George Mason University.

I. Educational Activities.

A. Veterinary Clinic. Purdue University ("Purdue") operates a veterinary clinic as a part of the education and training of students enrolled in its veterinary medicine programs. This activity does not generate any net income because student training is very inefficient and costly. However, it is Purdue's policy to charge as much as, if not more than, private veterinary clinics in the area specifically in order to avoid unfair competition with local veterinarians.

The University of Pennsylvania ("Penn") has a veterinary facility which deals largely in referrals from other doctors or clinics. Thus, it offers specialized treatment not generally available in the locality and also is not in competition with local business. Texas A&M University ("Texas A&M") prices its veterinary (and hospital) services to cover the cost of those facilities. None of these schools treats its veterinary clinic as an unrelated business.

B. Hearing Clinic. Purdue operates a clinic to train students in audiology, including the fitting and selling of hearing aids. To avoid competition with local businesses, this clinic restricts the number of hearing aids sold each year to the minimum necessary for adequate student training. It also charges at least as much as the local market rate.

C. Pharmacy. Purdue operates a student training pharmacy on campus as part of the instructional activities for students enrolled in pharmacy studies. Use of the pharmacy has historically been restricted to students and their dependents; however, access was recently extended to retired university employees for the express purpose of training students in dispensing the types of prescriptions typically needed by an older population and thereby expanding the training drug spectrum. The pharmacy's prices are the highest of the three local pharmacies, and sales of over-the-counter products are severely limited to minimize any competitive impact.

Before its pharmacy services were made available to retired employees, the university met with local druggists to explain the need for this expansion. While the private druggists had originally voiced concern over the increased competition, as a result of the meeting, they now understand the university's interest.

D. Nursery. Purdue operates a school nursery (which preceded similar commercial business activity) as part of the instruction of students preparing for careers in early childhood education. The university now restricts access and charges a slightly higher rate than commercial facilities in the area.

E. Meat Laboratories. Purdue's animal science studies laboratory operates an adjunct retail store to dispose of excess meat created as a by-product of education and research requiring the production of consumable meats. Prices are set so as not to undercut local competition. The university has continually made efforts to dispose of these meat by-products through local merchants, and some meat is sold wholesale. However, local merchants are generally not interested.

F. Hospital. Purdue does not have a medical school. Its hospital, which is solely for student use, was established at a time when local facilities were not adequate. It is a self-supporting, but not profitable, enterprise. Many of the in-patient services of the hospital, such as surgery and long-term care, have been eliminated and referred to private hospitals. Penn operates a teaching hospital and associated pharmacy which is restricted to use by patients of the hospital.

By contrast, the University of Southern California ("USC") Medical School provides patient care, supervision, teaching and administrative support for a 2200-bed county hospital and also operates the adjunct clinical laboratories. The county has tried but failed to interest local businesses in taking over these laboratories, and the school would gladly get out of this business if it could. Since students are not trained in these laboratories, they have been treated as an unrelated business for federal income tax purposes.

II. Supporting Activities

A. Athletics. Purdue attempts to operate its college athletic programs on a break-even basis, covering full costs. All net revenues (from broadcasting of athletic events, sales of souvenirs and summer use of facilities for sports camps for junior high school and high school students) are dedicated to the support of the university's athletic programs and are treated as related. The university rarely rents any athletic facilities for private use and only when comparable commercial facilities are unavailable.

Purdue has golf courses which were built during the depression by the WPA under a contract which requires that they be open to the public. They are priced higher than other golf courses in the area in order to discourage public use, while university students get reduced rates.

As a matter of policy, Purdue does not permit persons other than students or university staff to use any of its athletic facilities. Local commercial hand-ball courts have complained recently that the university's rates (charged to students and employees) are not competitive, and these rates are now under review.

B. Student Union/Dining Facilities. Purdue operates a student union and cafeteria primarily intended for use by the university community although the public is admitted. The student union has bowling, billiards, a newstand, etc. There is also a small 250-room hotel restricted to university guests, campus recruiters and academic conference participants. These facilities are not advertised and do not have liquor licenses or provide other amenities designed to attract the general public. Penn has acquired a small hotel facility, the income from which is reported as UBIT.

Purdue's campus dining facilities, apart from the facilities located in the residence halls, are open during the summer and school vacations (other than specific holidays such as Christmas) because the campus is in use for conferences and on-going graduate instruction and research during that time. Universities which close dining facilites during the summer have received complaints from local governments because the employees claim unemployment compensation, and some universities consciously find uses for their facilities to avoid that controversy.

C. University Stores.

1. Computer Stores. Purdue does not sell computers directly. The university has encouraged local computer

stores to provide discounts to its students, faculty and staff although the discounts ultimately offered by private vendors are considerably less than the discounts which could be obtained from manufacturers for direct university sales. The University of Michigan ("Michigan"), U.S.C. and Texas A&M sell discount computers to students and faculty only, and local merchants have complained. Michigan believes that some manufacturers may make their student discount programs available to local merchants, and the university would cease to sell those products were that to occur. Many community colleges have undertaken discounted computer sales programs, where available, as part of their mission to spread the use of technology.

The universities which sell discount computers all indicated that manufacturers originally approached them, offering sizable discounts (up to 40% in the case of IBM) on sales to students and faculty. These programs could only be operated by the university and could not be transferred to local merchants. When Texas A&M attempted to convince local sellers to match these discounts, the merchants claimed that, due to already intense local competition, they could not afford deeper discounting to Texas A&M students and faculty. Since the university felt obliged to make these important educational tools affordable by as many students as possible, it subscribed to the program but restricted campus sales to hardware only with a limit of one per person. The result has been significant increases in sales of equipment upgrades, peripherals and software by local vendors.

2. Bookstores. Approximately one-half of the institutions interviewed own and operate a bookstore; the other half contract out bookstore operations. Complaints about bookstore operations from local businesses are rare. Of all the participants, only Penn allocates bookstore sales between related and unrelated use. This allocation is made according to the type of item sold (i.e., durables, such as cameras, versus books and supplies) rather than the status of the purchaser (university community versus general public). Penn treats sales of cameras and other durables as unrelated, but treats sales of Tee-shirts and university souvenirs as related.

The experience of the colleges and universities interviewed is as follows: Michigan leases space on campus to private bookstore operators which do not provide any student discounts. This space is available to any interested vendors. USC owns and operates a bookstore. Purdue does not own or operate bookstores on its main campus. Because there is no adequate local supplier at its regional campuses, Purdue does contract with private retailers through competitive bidding to operate bookstores in university facilities. Stanford's bookstore operates as a private co-op which provides rebates to co-op members from the university community. Texas A&M owns a bookstore which does not provide student discounts but applies all net revenues to support student activities. George Mason University ("George Mason") contracts out its bookstore operations. Overall, the community colleges are similarly divided between those who own and those who contract out.

D. Audio/Visual. Many universities belong to a national association which shares (and shares profits from rentals of) audio/visual materials, such as documentaries and educational software. However, the organization also engages in some private rentals and carries some commercial (i.e., non-educational) titles.

Many community colleges operate a cable TV channel and produce and transmit educational programming. For example, we understand that the University of Miami at Dade produces small business training videos and other educational materials. In general, colleges and universities began these activities before any private business was willing to enter the field and often rely on the profitable segments to support a broader university enterprise.

Colleges in Texas, California and Florida operate literacy centers. Again, for-profit businesses were not interested in this activity initially.

E. Travel. Of the institutions interviewed, only USC maintains a travel agency for travel unrelated to educational matters (university programs, conferences, etc.). In USC's case, this operation has produced consistent revenue losses. When the university was audited in 1978, IRS agents insisted that the travel business be listed on the form 990T as an unrelated activity. After the 1982 audit, the IRS agents insisted that travel be dropped from the form 990T because, since the activity consistently lost money, it could not be considered as entered into for profit. It appears to be generally accepted that non-educational travel services are unrelated businesses; however, some schools treat alumni tours as development activities which are not taxable.

III. Research Activities

None of the universities interviewed engaged in research joint ventures or limited partnerships. One university was considering accepting, in lieu of a royalty interest, stock in a start-up company formed to develop university technology (subject to the approval of its legal counsel).

There are demonstrable private industry benefits from these activities. For example, Purdue maintains a facility for the study of manufacturing technology and automation for the purpose of equipping American business to respond to competitive challenges. Corporations assign employees to work at the facility alongside Purdue faculty and students. The university does not patent any of this technology, and the endeavor is fully cooperative with, and funded by, private business.

Most universities restrict the use of their laboratories to research which has an educational component. Further, because universities invariably assert proprietary ownership of all technology developed in campus facilities, faculty do not use university laboratories for unauthorized commercial projects. In fact, many universities have received complaints from private businesses for refusing to participate in testing and product development.

Virtually every research university has developed significant scientific advances--for example, Penn has developed a plastic polymer battery, now licensed to Allied Industries for development, which should be on the market shortly. Allegedly, more than one third of our total gross national product is attributable to post World War II basic research, 75% of which is conducted at colleges and universities. Moreover, without the ability to continue scientific research, the universities would lose expert faculty, and the quality of education of future private sector employees would suffer severely.

IV. Community Service

Colleges and universities generally acknowledge an obligation to foster economic development in their local communities, both to compensate them for lost property tax revenues and because, as in the case of community colleges, community service is a direct part of their mission. Community colleges, for example, often manage private industry councils, provide child care centers (started before private businesses were willing to undertake such activities), sponsor personnel exchanges for vocational training, provide educational training programming for local cable TV, participate in local agricultural conservation efforts, maintain computer facilities for local users, etc.

Occasionally, universities, such as Ohio State, have been asked by the State governments to provide consulting services to local businesses. The universities have tried to strike a balance between refraining from private sector competition and complying with such requests. Invariably, however, the presence of a college or university will contribute significantly to the local economy through its direct spending and the attraction of auxiliary business.

V. UBIT Experience

Most of the schools interviewed file a form 990T. Purdue earned net revenues primarily from operating its 6,000 seat music facility for summer conferences. Michigan settled an extensive audit by agreeing to pay some additional taxes for the prior two years. Michigan's taxable income is primarily attributable to sales of excess computer time to private users and to sales of seasonal excess capacity in university facilities, such as athletic facilities and dormitories.

USC has net unrelated business income from events parking, from a testing facility at its engineering school which is not used for student training and from use of its campus by film production companies. It reports losses from the hospital laboratories discussed above and, in prior years, reported losses from its travel service which the IRS now claims is not a for-profit activity.

Penn reports UBI from the rental of two facilities: its tennis facility, and its ice rink, from advertising in alumni magazines, from donated working interests in oil and gas, from bookstore sales of durables, and from a small hotel.

VI. Compliance

Colleges and universities have found that, while the forms 990 and 990T may not provide adequate data on business activities, Treasury regulations are overly detailed in some areas. For example, museum gift shops, bookstores, etc. must scrutinize their inventory item by item in order to separate, e.g., sales of postcards of artworks from the museum collection (related) from sales of postcards of other artworks not in the museum collection (unrelated). Further, the IRS is extremely aggressive in attempting to create unrelated business income by disallowing costs and prohibiting offsets of loss activities against profitable activities, both of which would readily be permitted to a private enterprise. It was generally felt that some progress could be made in the compliance area if the IRS would issue regulations defining related activities in the specific context of a college or university, and also make the compliance burdens more reasonable.

VII. Summary

The universities surveyed believe that the UBIT is a workable statute. Further, in the areas of cost deductions and offsets of loss activities against profitable activities, the IRS appears to treat exempt organizations much more harshly than for-profit businesses, so that an exempt organization's taxable income from an unrelated venture will arguably exceed the taxable income of a comparable for-profit corporation.

Many schools undertook what are now competitive activities because of a lack of available local resources. When these activities proved profitable, private businesses moved into the area. Universities will often cede such activities (e.g., the bookstores) to the for-profits, but are unable to do so where the profitable activity is used to support related revenue-losing activities in the universities' aggregate service areas. Small business wishes to do only the profitable activities and to leave universities with those which traditionally lose money.

The universities surveyed tended to avoid competition with local business whenever possible. Where university participation is deemed necessary, the universities tend to conduct their activities on the most modest scale which meets their needs so as not to divert business from private enterprise. For example, universities will decline liquor licenses at campus hotels, give priority to non-profit and academic rentals of their facilities, price services higher than local competitors to discourage public use, etc.

Texas A&M is faced with a state law prohibition on use of government revenues to support any of its auxiliary activities. Therefore, it has developed close working relationships with the local business community, both to attract needed services from the private sector and to structure university services around private sector activities. For example, the university provides limited bus service for its commuting students (which the public can use) but does not overlap available commercial service to community business areas. The university has also established a committee to conduct frequent dialogues with local business leaders which has enabled it to inform local businesses of university needs, such as day care facilities, and to adjust university activities to promote local business. When Texas A&M adopted the manufacturers' computer discount program discussed above, it restricted university sales to hardware and limited purchases to one per student in order to develop business for the local computer outlets in upgrades and software. The university has also stopped some activities, such as permitting local high schools students to use its pool, when local businesses demonstrated that adequate facilities had become available outside of the university.

Many colleges and universities charge for their community service activities only enough to cover costs. For example, Penn State began its soil testing business in 1887 as part of its land grant mandate for public service. (Generally, these mandates are reflected in the university charters and often in State law as well.) These services are still priced at cost in order to continue the community involvement despite the emergence of private competitors.

NACUBO
National Association of College and University Business Officers
One Dupont Circle, Suite 500, Washington, D.C. 20036-1178 • Telephone 202-861-2500

July 17, 1987

The Honorable J. J. Pickle
U.S. House of Representatives
242 Cannon House Office Building
Washington, D.C. 20515-4310

Dear Congressman Pickle:

I am writing to you as Chairman of the Subcommittee on Oversight of the Ways and Means Committee concerning the work of the National Association of College and University Business Officers (NACUBO) on the subject of the Unrelated Business Income Tax (UBIT). I have enclosed with this letter selected documents which NACUBO offers as a supplement to the testimony presented to the Subcommittee at its June 25 hearing to review UBIT by Thomas Mason, Vice President for Business Affairs at the University of Notre Dame on behalf of NACUBO. I hope you will share this information with other committee members and staff and that this letter and the enclosed documents may become part of the official hearing record.

NACUBO is a national association that represents more than 2,000 colleges and universities. The topic of taxation of unrelated business income is one that the association has addressed on several occasions during the past. Most recently we have responded to the interest of the Congress and the higher education community on this issue by forming the Policy Task Force on Business Competition and participating in the recent hearing conducted by the Subcommittee on Oversight. Two principal activities have been the conduct of a survey of our membership and the adoption and issuance of a NACUBO policy statement and guidelines to member institutions.

NACUBO Survey of Unrelated Business Income. NACUBO mailed a questionnaire to a stratified, random sample of 481 colleges and universities in late December 1986. The survey asked institutions to provide detailed information about their experience in providing and/or contracting out of 22 different types of services and reporting of unrelated business income. One hundred ninety-five (195), or 40 percent of the schools polled, responded to the questionnaire. A copy of the detailed results of the survey, provided as Attachment A, are enclosed for your review. In addition, a summary of the results, published as a "NACUBO Report" in the Business Officer, serves as Attachment B.

NACUBO Policy Statement and Guidelines. In response to the findings of the NACUBO survey, the Policy Task Force on Business Competition developed a policy statement and guidelines. The NACUBO Board of Directors approved in principle the statement and guidelines at its March 20, 1987 meeting and an exposure draft was issued to the full membership on March 26.

It is important to note that several colleges and universities have created and currently use their own policies with regard to unrelated business income. (For the purpose of illustration, I have enclosed with this letter a copy of the University of Washington's Policy on Sales of Goods and Services

— see Attachment D). It should be understood that the NACUBO policy has been developed to allow other institutions to adopt the statement and guidelines directly as their own policy or serve as a base for the development of more detailed policies at individual institutions. Given this intent, the NACUBO policy statement and guidelines are general and broad because of differences among institutions with regard to unrelated business income activities.

At its meeting on July 12, the NACUBO Board of Directors adopted the "Policy Statement and Guidelines on Educational Business Activities of Colleges and Universities" and approved its issuance to the full membership. A copy of the statement and guidelines is provided as Attachment C. We firmly believe that provision of the policy statement and guidelines will further assist colleges and universities in their self-regulation of educational business activities.

It is also important to note that two other higher education associations, the National Association of College Stores (NACS) and the National Association of College Auxiliary Services (NACAS), have adopted the NACUBO policy statement and guidelines. As a group, NACS, NACAS and NACUBO represents approximately two-thirds of all colleges and universities in the United States.

For the purpose of further educating institutions in higher education about the taxation of unrelated business income, NACUBO plans to develop and promote with other national associations, including NACS and NACAS among others, programs in accordance with the NACUBO policy statement and guidelines.

NACUBO appreciates this opportunity to work with the Congress in its review of UBIT. I hope you will continue to call upon NACUBO for information and technical assistance on the issue as the Subcommittee proceeds with its deliberations. Thank you for your interest in our work on UBIT, consideration of our testimony, and review of the enclosed materials.

Sincerely,

Caspa L. Harris, Jr.
Executive Vice President

Enclosures

cc: Russlyn Guritz, Chief Counsel

ATTACHMENT A

Anne C. Gross
February 11, 1987

Results of NACUBO's Unrelated Business Income Survey

The unrelated business income survey was mailed to chief business officers at 481 institutions in a random sample chosen from a universe of 2,631 higher education institutions. The sample was stratified for type (two year/four year/university), control (public/independent), and geographic region. The overall response rate was 40% (195 responses) with a fairly even response rate by type and control except for a low response by independent two year colleges. Since only twelve independent two year schools responded, care should be used when looking at the results from this group.

Table 1 compares the institutions that answered the survey to both the universe and the stratified random sample. Table 2 shows the respondents by type, control and enrollment.

Part II Unrelated Business Activities

IIA. Auxiliary Corporations - Thirty nine institutions (20%) reported providing some services through a separate institutional-related nonprofit auxiliary corporation. Most of these were public schools with the breakdown by type and control as follows:

15	(38%)	Public Four Year and Universities
15	(38%)	Public Two Year
2	(5%)	Independent Four Year and Universities
7	(18%)	Independent Two Year

IIB. Services Provided - Table 3 gives the breakdown by type and control of institutitons which reported offering the services listed in the survey. Predictably, the services most frequently cited were food services (88.2%), bookstores (97.4%), copying and duplicating (92.8%), and audio-visual services (84.1%). Facilities rental and concerts also were widely offered. Table 4 breaks down this same information by enrollment rather than type and control. This breakdown follows intuitive sense in that larger schools offer more services.

An important issue that has been raised is when colleges began to offer wider arrays of services, with the contention that there has been a large increase recently. Table 5 gives the breakdown of each service by when schools reported they began offering it. The percentages given are of the number who gave an answer for "year began". In some instances quite a few who reported having a service did not supply data about the year. This breakdown does not show a large increase in services over the last decade, except in a few areas such as those related to newly available technology. The services where a majority reported the "year began" since 1975 are:

Services Which the Majority Reported Starting Since 1975

		Number Offering Service*	Percent Since 1975
4a.	Computer Sales - inst. only	60	98.3%
4b.	Computer Sales - general public	7	71.4%
5.	Sales of Computer Time	21	52.4%
9b.	Radio/TV - commercial	10	60.0%
10a.	Videotape Rental - educational only	9	88.9%
10b.	Videotape Rental - variety	10	80.0%
14b.	Travel Services - any activity	11	63.6%
15a.	Alumni Tours - alumni only	27	59.3%
15b.	Alumni Tours - general public	16	50.0%
20.	Summer Camps	68	58.8%

*includes only those who answered "year began"

For only three services did the majority indicate the "year began" before 1960: student housing, food services, and bookstores than sold course materials only. Starting years that were long ago were probably somewhat more likely not reported, however, since the person answering the questionnaire would not know the answer.

Another important issue is the extent to which institutions contract with outside firms to provide services. This is a ranking of the services that more than ten percent of the schools offering reported contracting out:

Ranking of Services Most Often Contracted Out*

		Number with Service	Percent Contracted Out
14b.	Travel Services - any activity	15	60.0%
2.	Restaurant/Cafeteria	172	59.9
12.	Broadcasting of Athletic Contests	68	36.8
21.	Instruct/Research Equip. Rental	6	33.3
3a.	Bookstore - course materials only	15	20.0
15b.	Alumni Tours - general public	28	17.9
7b.	Printing + Publishing - gen. public	23	17.4
14a.	Travel Services - inst. related	58	17.2
3b.	Bookstore/Gift Shop	175	17.1
13b.	Photo Services - general public	12	16.7
17.	Bike Shop	8	12.5
4b.	Computer Sales - general public	9	11.1

*This listing inlcudes all services where more than ten percent of the institutions who offered the service reported contracting out.

Table 6 shows the percent contracted out for all services.

A listing of the responses to question B.23. "Other Services" is attached.

IIC. Activities - Table 7 gives the responses by type and control about various activities schools may engage in. Advertising was by far the most often cited. Two year colleges engaged in very few other activities listed, while public four year colleges and universities were much more involved in all of them than any other group.

IID. Services Provided by Organizations Not Under Direct Authority and Control of Institution - Only eighteen institutions (9%) reported that any of the services or activities listed were provided by organizations not under the direct control of the institution. (Many of these did not circle any particular services or activities.) Those services and activities cited included:

Services	# times cited
2. Restaurant/Cafeteria	3
5. Sales of Computer Time	1
9c. Radio/TV (PBS)	1
10a. Rental of Videotapes - educational	1
11b. Audio Visual Services - general public	1
12. Broadcasting of Athletic Contests	1
14a. Travel Services - institutional only	1
14b. Travel Services - any activity	2
15b. Alumni Tours - general public	2
16. Lecture Series	1
18. Child Care Services	2
22b. Concerts - general public	1

Activities	
2. Advertising	3
3. Licensing of Institutional Logo/Memorabilia	4
4. Patent Agreements	1
5. Royalty Agreements	1

IIE. and IIF. IRS Form 990-T - For 1985, thirty seven institutions (19%) who responded had filed Form 990-T with the IRS. The vast majority of these were independent four year colleges and universities. The following table shows who filed 990-T's by type and control:

Institutions which Filed 990-T

	before 1982	1982	1983	1984	1985	1986
Ind. Two Year (n = 12)	2	2	2	2	2	2
Ind. Four Yr. (n = 73)	29	26	27	29	30	30
Public Two Year (n = 65)	2	2	2	2	2	2
Public Four Yr. (n = 45)	3	4	4	4	3	4
TOTAL	36	34	35	37	37	38

Using 1985 as a representative year for discussion of the amount of income reported and taxes paid, thirty four schools supplied the necessary information. Of these:

12 reported either 0 income or "a loss"

15 reported positive income with an average of $85,169 and a range from $1,054 to $344,990

7 reported losses ranging from $-4,203 to $-297,291 with an average of $-56,928.

Thirty two schools gave us information for 1985 on taxes paid:

24 reported paying no tax

8 reported paying tax with an average of $1,462 and a range from $59 to $5,000.

IIG. Audits - Thirty seven institutions (19%) reported having been audited for unrelated business income, including 29 independent universities and four year colleges, 6 public universities and four year colleges, one independent and one public two year college. Of these, only three reported that the IRS made exceptions or disallowances; three audits are still open; three schools reported being required to file 990-T's; and twenty four reported no problems found or resolved in favor of the institution. The respondents detailed answers to questions about the outcome of audits are included in Attachment 2.

Of the thirty seven schools that have been audited, 23 (62%) filed 990-T's in 1985 and plan to file in 1986. Because we do not know when schools began to file 990-T's or when they were audited, we cannot say what the relationship is between filing and being audited. The following breakdown compares those schools which filed 990-T's in 1985 with those schools which have been audited, by type and control:

Filing 990-T's vs. Audited

	Public		Private	
	4YR	2YR	4YR	2YR
Filed 990-T 1985	3	2	30	2
Of those who filed # been audited	1	1	20	1
# audited who did not file	5	0	9	0

Part III Business Competition Issues and Policies

IIIA. Legal Action - Only six schools (3%) who answered the survey reported having had legal action filed against the institution claiming "unfair competition". With the exception of one independent four year college, all were public universities or four year colleges. One additional institution reported being threatened with action for computer sales at the bookstore. Two of the six schools reported action that had taken place during the 1960's. The services cited in legal action included:

bookstore (2)
hotel and conference facilities
parking
computer store
pizza sales
travel
copy center
aquatic center

Detailed responses to this question are included in Attachment 2.

IIIB. Legislation - Respondents were aware of legislative action or proposed legislation restricting operation of tax-exempt entities in twenty states, including:

Alabama
California
Georgia
Idaho
Illinois
Indiana
Iowa
Kentucky
Massachusetts
Michigan
Minnesota
North Carolina
New Jersey
Ohio
Oregon
Pennsylvania
Utah
Virginia
Washington
Wisconsin

IIIC. Institutional Policies - Only twenty one respondents (11%) reported that their institution had developed policies or guidelines for commercial activities. Of these, 11 were public universities or four year colleges, 5 were independent universities or four year colleges, 3 were public two year colleges and 2 were private two year colleges. Those policies that were submitted with the survey are being provided to the Task Force.

ATTACHMENT 2

UNRELATED BUSINESS INCOME SURVEY
LONG ANSWERS
FEBRUARY 2, 1987

SCHOOLS WITH OTHER SERVICES

CON	TYPE	RESPONSE
PUB	ANY	Telephone services to faculty, staff and students
PUB	2YR	Institutional/Community Research, 1972
PUB	2YR	Summer training camp for pro football team, 1982
PUB	4YR	Rental Center (outdoor equipment), 1980; Film Series, 1968-70; Roller skating rink, 1972; Beauty Shop, 1967; Book exchange (Student operated), 1973; Bowling, Billiards, Game Room, 1967; Post Office outlet, 1982; Automatic Teller (Bank), 1981; Craft Center, 1973; Vending, 1960's
PUB	4YR	Library Services to City community, 1940
PUB	4YR	Clinic, Telephone, Continuing education, lab animals, vehicle rental, surplus property disposal, theatre, parking, pharmacy substance abuse program (DWI, etc. program), study tours, marketing studies, exercise, conditioning, health eval., music lessons, instrument rental, counseling services, monographs, locker rentals
PUB	4YR	Laundry Service-Coin Op machines, Contracted, 1973; Amusements-Video games, etc., Contracted, 1973; Hair Style Shop, Contracted, 1970; Ski & Canoe Rental - Fieldhouse; 1973
PUB	UNI	Parking
PUB	2YR	Theatre Tour - Drama Dept, Related - Students and Public; 1971
PUB	2YR	Interpreters for deaf students
PUB	4YR	Banking, 1986; Game room, 1973; Athletic Equipment Rental; Planetarium Programs
PUB	UNI	Indoor arena rental, 1986; airport, 1938; planetarium, 1949; art museum, 1958; laundry, 1935; botanical garden, 1952; dramatic performances, 1918; golf course at least 25 years
PUB	UNI	Mail services for university departments, 1960; Technical fabrication, milling and manufacturing of research devices, 1940;

CON	TYPE	RESPONSE
IND	4YR	Ice Skating - Institutional & General Public, 1968; Catering Services, 1968
IND	4YR	Grocery Store for institutional community, 1985
IND	4YR	Laundry to another college, 1974
PUB	UNI	Lime Stone Mining (Endowment) Royalties, 1983; Rental of Related Interspace, 1986
IND	4YR	Theatre operation, 1925
IND	UNI	We run a bus services for students who do not live on campus
IND	2YR	Recreational Facilities (R-C Ranch) (Campus community & general public), 1979
IND	UNI	Ticket Office, Theatre, Pharmacy, Barber shop

SCHOOLS WITH OUTCOME OF AUDITS

PUB	2YR	There were no exceptions. It was a clean audit per letter dated 11/7/86. Date of audit: April, 1986
PUB	UNI	No findings
PUB	4YR	No findings
PUB	4YR	The parent institution is negotiating the outcome
PUB	4YR	Still pending
PUB	UNI	No unrelated income
PUB	UNI	IRS conceded that income from university operated utilities at a time when the service was also sold to the adjacent community was not unrelated business income.
IND	4YR	No change
IND	4YR	Tax returns accepted by IRS as originally filed.
IND	4YR	Unqualified opinion
IND	4YR	Had to file 990T for FY81 and 82
IND	4YR	There was no change
IND	4YR	No income found, no penalties assessed

CON	TYPE	RESPONSE
IND	4YR	Satisfactorily resolved
IND	4YR	IRS is challenging the expense allocation on the cost of providing laundry services to another college. They have claimed taxes due of $1,503 (FY 83) and a penalty of $376. We have appealed to the District Director.
IND	4YR	IRS found everything acceptable
IND	UNI	Fiscal year 1982, $500,000 of UBI items cited; all items settled in our favor. Items principally related to sale of computer time, and athletic fees
IND	UNI	Found to be in compliance
IND	4YR	Audited for rental of facilities - were told we could not advertise as conference center and were advised not to provide room service (cleaning, etc) to rented dormitory rooms once they were occupied or we must charge room tax and could lose non-profit status
IND	4YR	No assessment
IND	4YR	No tax liability
IND	4YR	Resulting income, after full allocation of costs, was not materially affected.
IND	4YR	No exceptions found - method of calculating and allocating overhead costs found acceptable
IND	4YR	Forms filed were affirmed
IND	4YR	The only enterprise we reported on the 990T is the operation related to the publication of Literary Review. No other activities have ever been challenged.
IND	4YR	Required to file 990T covering outside income from (1) printing - duplicating (2)summer conference operations (3) computer service/time sales (retroactive for 3 years) starting about 1976
IND	4YR	Paid $100 each of 2 year
IND	4YR	Determination that all auxiliaries were related income

CON	TYPE	RESPONSE
IND	2YR	Our records were in order
IND	4YR	No problems, no change exemption continued
IND	4YR	990T's were required to be filed annually
IND	4YR	No changes
IND	UNI	No findings for 990T apparently they concluded that the 990T's were ok
IND	UNI	No exceptions and no disallowances
EXCEPTIONS TO AUDITS		
IND	4YR	Sold coomputer time to local corporation
IND	4YR	Rental farmland (not used ofr educational purposes were declared unrelated income
PUB	UNI	University conceded that income from the operation of a hotel would be considered unrelated business income, but no profit has ever been shown from the operation of this facility
SCHOOLS WITH IIIA CITATIONS		
PUB	4YR	YES - Bookstore activities
PUB	UNI	YES - 1962--Hotel Association sued to deny right to construct hotel and conference facilities as an addition to Memorial Union; 1969--City instituted action to prevent the building of parking ramps. University prevailed in both cases.
PUB	UNI	YES - Computer Store, Dormitory Selling Pizza
PUB	UNI	YES - Travel Services
PUB	UNI	NO - but has been threatened for computer sales at the bookstore
PUB	4YR	YES - (1) Aquatic Center (2) Copy Center
IND	4YR	YES - Bookstore sort goods sales - state sales tax issue but in early 1960's

TABLE 1

UNRELATED BUSINESS INCOME SURVEY

RESPONSE RATE AS OF FEBRUARY 4, 1987

			UNIVERSE	SAMPLE	RESPONDERS	% OF SAMPLE	% OF UNIVERSE
PUBLIC	TWO YEAR	NORTHEAST	151	29	12	41.4	7.9
		MIDWEST	243	46	17	37.0	7.0
		SOUTH	326	59	19	32.2	5.8
		WEST	221	41	17	41.5	7.7
			941	175	65	37.1	6.9
	FOUR YEAR	NORTHEAST	84	16	3	18.8	3.6
		MIDWEST	84	16	9	56.3	10.7
		SOUTH	162	30	15	50.0	9.3
		WEST	53	10	6	60.0	11.3
			383	72	33	45.8	8.6
	UNIVERSITY	NORTHEAST	14	3	1	33.3	7.1
		MIDWEST	31	6	3	50.0	9.7
		SOUTH	34	7	4	57.1	11.8
		WEST	25	6	4	66.7	16.0
			104	22	12	54.5	11.5
INDEPENDENT	TWO YEAR	NORTHEAST	120	22	6	27.3	5.0
		MIDWEST	85	13	2	15.4	2.4
		SOUTH	129	20	3	15.0	2.3
		WEST	32	6	1	16.7	3.1
			366	61	12	19.7	3.3
	FOUR YEAR	NORTHEAST	204	38	16	42.1	7.8
		MIDWEST	240	44	30	68.2	12.5
		SOUTH	234	43	13	30.2	5.6
		WEST	88	14	9	64.3	10.2
			766	139	68	48.9	8.9
	UNIVERSITY	NORTHEAST	26	5	2	40.0	7.7
		MIDWEST	11	2	0	0.0	0.0
		SOUTH	15	3	2	66.7	13.3
		WEST	7	2	1	50.0	14.3
			59	12	5	41.7	8.5
GRAND TOTAL			2631	481	195	40.5	7.4

TABLE 2

2/4/87

UNRELATED BUSINESS INCOME SURVEY

DISTRIBUTION OF RESPONDENTS BY ENROLLMENT

ENROLLMENT	PUBLIC 4YR & UNI	INDEPENDENT 4YR & UNI	PUBLIC 2YR	INDEPENDENT 2YR	OVERALL
less than 1,000	0	29	7	9	45 (23.1%)
1,000 - 2,500	1	23	19	2	45 (23.1%)
2,500 - 5,000	14	12	16	0	42 (21.5%)
5,000 - 10,000	9	5	14	1	29 (14.9%)
10.000 - 20,000	14	3	4	0	21 (10.8%)
over 20,000	7	1	5	0	13 (6.7%)
	43	73	63	12	195 (100.0%)

TABLE 3

2/4/87

UNRELATED BUSINESS INCOME SURVEY

DISTRIBUTION OF SERVICES PROVIDED
BY TYPE AND CONTROL

SERVICE PROVIDED	4YR AND UNIVERSITIES		TWO YEAR		
	PUBLIC (n=45)	PRIVATE (n=73)	PUBLIC (n=65)	PRIVATE (n=12)	TOTAL (n=195)
1. STUDENT HOUSING	93.3	89.0	15.4	75.0	64.6
2. RESTAURANT/ CAFETERIA	100.0	90.4	80.0	75.0	88.2
3. a. BOOKSTORE - COURSE BOOKS AND REQUIRED EQUIPMENT ONLY	4.4	5.5	12.3	8.3	7.7
b. BOOKSTORE/ GIFTSHOP	93.3	93.2	84.6	83.3	89.7
4. a. COMPUTER SALES - TO CAMPUS COMMUNITY	51.1	49.3	20.0	33.3	39.0
b. COMPUTER SALES TO CAMPUS COMMUNITY AND GENERAL PUBLIC	8.9	5.5	0.0	8.3	4.6
5. SALES OF COMPUTER TIME	37.8	16.4	6.2	16.6	17.9
6. a. CLASSROOM RENTAL	73.3	71.2	64.6	75.0	69.7
b. ATHLETIC FACILITIES RENTAL	75.6	65.8	50.8	75.0	63.6
c. CONFERENCE FACILITIES RENTAL	82.2	76.7	56.9	66.7	70.8
d. DORMITORY ROOM RENTAL DURING VACTION PERIODS	73.3	75.3	10.8	66.7	52.8
7. a. PRINTING AND PUBLISHING FOR INSTITUTIONAL COMMUNITY ONLY	57.8	34.2	55.4	25.0	46.2
b. PRINTING AND PUBLISHING GENERAL PUBLIC	20.0	13.7	3.1	16.6	11.8
8. a. COPYING AND DUPLICATING - INST COMMUNITY ONLY	73.3	79.5	78.5	83.3	77.9
b. COPYING AND DUPLICATING - GENERAL PUBLIC	20.0	19.2	6.2	16.6	14.9
9. a. RADIO & TV - INTERNAL ONLY	26.7	24.7	12.3	16.6	20.5
b. RADIO/TV - INTERNAL AND EXTERNAL	13.3	4.1	9.2	16.6	8.7
c. RADIO/TV - PBS	48.9	21.9	15.4	16.6	25.6

	4YR AND UNIVERSITIES		TWO YEAR		
	PUBLIC (n=45)	PRIVATE (n=73)	PUBLIC (n=65)	PRIVATE (n=12)	TOTAL (n=195)
10. a. RENTAL OF VIDEOTAPES - EDUCATIONAL ONLY	28.9	8.2	3.1	0.0	10.8
b. RENTAL OF VIDEOTAPES - WIDE VARIETY	15.6	4.1	1.5	25.0	7.2
11. a. AUDIO VISUAL - INST COMMUNITY ONLY	68.9	80.8	66.2	58.3	71.8
b. AUDIO VISUAL - GENERAL PUBLIC	22.2	6.8	12.3	8.3	12.3
12. BROADCASTING OF ATHLETIC CONTESTS	62.2	31.5	21.5	25.0	34.9
13. a. PHOTO SERVICES INST COMMUNITY ONLY	42.2	38.4	40.0	41.7	40.0
b. PHOTO SERVICES - GENERAL PUBLIC	15.6	5.5	0.0	8.3	6.2
14. a. TRAVEL - INSTITUTIONAL RELATED ONLY	35.6	26.0	32.3	16.6	29.7
b. TRAVEL ANY ACTIVITY	17.8	8.2	0.0	8.3	7.7
15. a. ALUMNI TOURS - INSTITUTION ONLY	31.1	34.2	6.2	16.6	23.1
b. ALUMNI TOURS - GENERAL PUBLIC	24.4	16.4	6.2	8.3	14.4
16. LECTURE SERIES	68.9	54.8	36.9	50.0	51.8
17. BIKE SHOP	11.1	1.4	1.5	8.3	4.1
18. CHILD CARE SERVICES	48.9	17.8	46.2	41.7	35.9
19. ANALYTICAL TESTING	57.8	17.8	23.1	50.0	30.7
20. SUMMER CAMPS	80.0	64.4	26.2	66.7	55.4
21. INSTITUTIONAL / RESEARCH EQUIPMENT	8.9	0.0	1.5	8.3	3.1
22. a. CONCERTS - INSTITUTIONAL ONLY	6.7	8.2	9.2	16.6	8.7
b. CONCERTS - GENERAL PUBLIC	93.3	72.6	56.9	58.3	71.3

TABLE 4

2/4/87

UNRELATED BUSINESS INCOME SURVEY

DISTRIBUTION OF SERVICES PROVIDED
BY ENROLLMENT

SERVICE PROVIDED	ENROLLMENT			
	LESS THAN 2,500 (n=90)	2,500-10,000 (n=71)	OVER 10,000 (n=34)	TOTAL (n=195)
1. STUDENT HOUSING	67.8%	56.3%	73.5%	64.6%
2. RESTAURANT/ CAFETERIA	78.9	95.8	97.1	88.2
3. a. BOOKSTORE - COURSE BOOKS AND REQUIRED EQUIPMENT ONLY	12.2	4.2	2.9	7.7
b. BOOKSTORE/ GIFTSHOP	85.6	93.0	94.1	89.7
4. a. COMPUTER SALES - TO CAMPUS COMMUNITY	32.2	39.4	55.9 8.8	39.0
b. COMPUTER SALES TO CAMPUS COMMUNITY AND GENERAL PUBLIC	5.6	1.4	8.8	4.6
5. SALES OF COMPUTER TIME	6.7	21.1	41.2	17.9
6. a. CLASSROOM RENTAL	58.9%	76.0%	85.3%	69.7%
b. ATHLETIC FACILITIES RENTAL	54.4	63.4	88.2	63.6
c. CONFERENCE FACILITIES RENTAL	65.6	67.6	91.2	70.8
d. DORMITORY ROOM RENTAL DURING VACTION PERIODS	56.7	42.2	64.7	52.8
7. a. PRINTING AND PUBLISHING FOR INSTITUTIONAL COMMUNITY ONLY	32.2	59.1	55.9	46.2
b. PRINTING AND PUBLISHING - GENERAL PUBLIC	11.1	8.5	20.6	11.8
8. a. COPYING AND DUPLICATING - INST COMMUNITY ONLY	81.1	71.8	82.4	77.9
b. COPYING AND DUPLICATING - GENERAL PUBLIC	12.2	18.3	14.7	14.9
9. a. RADIO & TV - INTERNAL ONLY	16.7	22.5	26.5	20.5
b. RADIO/TV - INTERNAL AND EXTERNAL	1.1	14.1	17.6	8.7
c. RADIO/TV - PBS	12.2	31.0	50.0	25.6

	LESS THAN 2,500 N=90	2,500-10,000 n=71	OVER 10,000 n=34	TOTAL n=195
10. a. RENTAL OF VIDEOTAPES - EDUCATIONAL ONLY	5.6%	9.9%	26.5%	10.8%
b. RENTAL OF VIDEOTAPES - WIDE VARIETY	4.4	8.5	11.8	7.2
11. a. AUDIO VISUAL - INST COMMUNITY ONLY	70.0	71.8	76.5	71.8
b. AUDIO VISUAL GENERAL PUBLIC	6.7	16.9	17.6	12.3
12. BROADCASTING OF ATHLETIC CONTESTS	26.7	36.6	52.9	34.9
13. a. PHOTO SERVICES - INST COMMUNITY ONLY	34.4	46.5	41.2	40.0
b. PHOTO SERVICES - GENERAL PUBLIC	2.2	5.6	17.6	6.2
14. a. TRAVEL - INSTITUTIONAL RELATED ONLY	21.1	35.2	41.2	29.7
b. TRAVEL ANY ACTIVITY	3.3	9.9	14.7	7.7
15. a. ALUMNI TOURS - INSTITUTION ONLY	17.8	22.5	38.2	23.1
b. ALUMNI TOURS - GENERAL PUBLIC	10.0	16.9	20.6	14.4
16. LECTURE SERIES	40.0	62.0	61.8	51.8
17. BIKE SHOP	2.2	2.8	11.8	4.1
18. CHILD CARE SERVICES	20.0	42.3	64.7	35.9
19. ANALYTICAL TESTING	15.6	36.6	58.8	30.7
20. SUMMER CAMPS	46.7	57.7	73.5	55.4
21. INSTRUCTIONAL/ RESEARCH	2.2	0.0	11.8	3.1
22. a. CONCERTS - INSTITUTIONAL ONLY	10.0	8.5	5.9	8.7
b. CONCERTS - GENERAL PUBLIC	60.0	76.1	91.2	71.3

TABLE 5

2/4/87

UNRELATED BUSINESS INCOME SURVEY

WHEN INSTITUTIONS BEGAN OFFERING-SERVICES

SERVICE PROVIDED	NUMBER THAT OFFERED SERVICES (NUMBER WHO ANSWERED "YEAR BEGAN")	YEAR BEGAN OFFERING SERVICES (PERCENTAGE OF THOSE WHO ANSWERED) BEFORE 1960	1960-1974	1975-AND LATER
1. STUDENT HOUSING	126 (101)	68.3%	29.7%	2.0%
2. RESTAURANT/ CAFETERIA	172 (130)	50.0	38.5	11.5
3. a. BOOKSTORE - COURSE BOOKS AND REQUIRED EQUIPMENT ONLY	15 (12)	50.0	33.3	16.7
b. BOOKSTORE/ GIFTSHOP	175 (134)	35.8	54.5	9.7
4. a. COMPUTER SALES - TO CAMPUS COMMUNITY	76 (60)	0.0	1.7	98.3
b. COMPUTER SALES TO CAMPUS COMMUNITY AND GENERAL PUBLIC	9 (7)	0.0	28.6	71.4
5. SALES OF COMPUTER TIME	35 (21)	0.0	47.6	52.4
6. a. CLASSROOM RENTAL	136 (86)	20.9	59.3	19.8
b. ATHLETIC FACILITIES RENTAL	124 (73)	16.4	56.2	27.4
c. CONFERENCE FACILITIES RENTAL	138 (84)	14.3	64.3	21.4
d. DORMITORY ROOM RENTAL DURING VACTION PERIODS	103 (61)	24.6	59.0	16.4
7. a. PRINTING AND PUBLISHING FOR INSTITUTIONAL COMMUNITY ONLY	90 (60)	25.0	60.0	15.0
b. PRINTING AND PUBLISHING GENERAL PUBLIC	23 (14)	42.9	14.3	42.9
8. a. COPYING AND DUPLICATING - INST COMMUNITY ONLY	152 (105)	20.0	61.9	18.1
b. COPYING AND DUPLICATING - GENERAL PUBLIC	29 (17)	23.5	47.1	29.4
9. a. RADIO & TV - INTERNAL ONLY	40 (34)	14.7	50.0	35.3
b. RADIO/TV - INTERNAL AND EXTERNAL	17 (10)	10.0	30.0	60.0
c. RADIO/TV - PBS	50 (35)	25.7	40.0	34.3

	NUMBER THAT OFFERED SERVICES (NUMBER WHO ANSWERED YEAR BEGAN)	YEAR BEGAN OFFERING SERVICES (PERCENTAGE OF THOSE WHO ANSWERED)		
		BEFORE 1960	1960-1974	1975-AND LATER
10. a. RENTAL OF VIDEOTAPES - EDUCATIONAL ONLY	21 (9)	0.0%	11.1%	88.9%
b. RENTAL OF VIDEOTAPES - WIDE VARIETY	14 (10)	0.0	20.0	80.0
11. a. AUDIO VISUAL INST COMMUNITY ONLY	140 (93)	17.2	69.9	12.9
b. AUDIO VISUAL - GENERAL PUBLIC	24 (13)	15.4	46.2	38.5
12. BROADCASTING OF ATHLETIC CONTESTS	68 (44)	27.3	36.4	36.4
13. a. PHOTO SERVICES - INST COMMUNITY ONLY	78 (43)	18.6	65.1	16.3
b. PHOTO SERVICES - GENERAL PUBLIC	12 (5)	20.0	80.0	0.0
14. a. TRAVEL - INSTITUTIONAL RELATED ONLY	58 (35)	14.3	51.4	34.3
b. TRAVEL ANY ACTIVITY	15 (11)	18.2	18.2	63.6
15. a. ALUMNI TOURS - INSTITUTION ONLY	45 (27)	7.4	33.3	59.3
b. ALUMNI TOURS GENERAL PUBLIC	28 (16)	0.0	50.0	50.0
16. LECTURE SERIES	101 (53)	22.6	47.2	30.2
17. BIKE SHOP	8 (5)	0.0	60.0	40.0
18. CHILD CARE SERVICES	70 (57)	0.0	52.6	47.4
19. ANALYTICAL TESTING	60 (38)	23.7	52.6	23.7
20. SUMMER CAMPS	108 (68)	13.2	27.9	58.8
21. INSTRUCTIONAL/ RESEARCH EQUIPMENT	6 (5)	20.0	40.0	40.0
22. a. CONCERTS - INSTITUTIONAL ONLY	17 (9)	44.4	33.3	22.2
b. CONCERTS - GENERAL PUBLIC	139 (87)	32.2	54.0	13.8

TABLE 6 2/4/87

UNRELATED BUSINESS INCOME SURVEY
PERCENTAGE OF THOSE WHO OFFERED SERVICE
WHO CONTRACTED OUT

SERVICE PROVIDED	# WHO OFFERED SERVICE n=195	# CONTRACTED OUT	% CONTRACTED OUT
1. STUDENT HOUSING	126	3	2.4%
2. RESTAURANT/CAFETERIA	172	103	59.9
3. a. BOOKSTORE - COURSE BOOKS AND REQUIRED EQUIPMENT ONLY	15	3	20.0
b. BOOKSTORE/GIFTSHOP	175	30	17.1
4. a. COMPUTER SALES - TO CAMPUS COMMUNITY	76	3	3.9
b. COMPUTER SALES TO CAMPUS COMMUNITY AND GENERAL PUBLIC	9	1	11.1
5. SALES OF COMPUTER TIME	35	1	2.9
6. a. CLASSROOM RENTAL	136	1	0.7
b. ATHLETIC FACILITIES RENTAL	124	1	0.8
c. CONFERENCE FACILITIES RENTAL	138	2	1.4
d. DORMITORY ROOM RENTAL DURING VACTION PERIODS	103	1	1.0
7. a. PRINTING AND PUBLISHING FOR INSTITUTIONAL COMMUNITY ONLY	90	3	3.3
b. PRINTING AND PUBLISHING - GENERAL PUBLIC	23	4	17.4
8. a. COPYING AND DUPLICATING - INST COMMUNITY ONLY	152	2	1.3
b. COPYING AND DUPLICATING - GENERAL PUBLIC	29	2	6.9
9. a. RADIO & TV - INTERNAL ONLY	40	0	0.0
b. RADIO/TV - INTERNAL AND EXTERNAL	17	1	5.9
c. RADIO/TV - PBS	50	3	6.0

	# WHO OFFERED SERVICE N=195	# CONTRACTED OUT	% CONTRACTED OUT
10. a. RENTAL OF VIDEOTAPES - EDUCATIONAL ONLY	21	0	0.0%
b. RENTAL OF VIDEOTAPES - WIDE VARIETY	14	1	7.1
11. a. AUDIO VISUAL - INST COMMUNITY ONLY	140	1	0.7
b. AUDIO VISUAL - GENERAL PUBLIC	24	2	8.3
12. BROADCASTING OF ATHLETIC CONTESTS	68	25	36.8
13. a. PHOTO SERVICES - INST COMMUNITY ONLY	78	6	7.7
b. PHOTO SERVICES - GENERAL PUBLIC	12	2	16.7
14. a. TRAVEL - INSTITUTIONAL RELATED ONLY	58	10	17.2
b. TRAVEL - ANY ACTIVITY	15	9	60.0
15. a. ALUMNI TOURS - INSTITUTION ONLY	45	4	8.9
b. ALUMNI TOURS - GENERAL PUBLIC	28	5	17.9
16. LECTURE SERIES	101	2	2.0
17. BIKE SHOP	8	1	12.5
18. CHILD CARE SERVICES	70	6	8.6
19. ANALYTICAL TESTING	60	0	0
20. SUMMER CAMPS	108	9	8.3
21. INSTRUCTIONAL / RESEARCH	6	2	33.3
22. a. CONCERTS - INSTITUTIONAL ONLY	17	1	5.9
b. CONCERTS - GENERAL PUBLIC	139	7	5.0

TABLE 7 2/4/87

UNRELATED BUSINESS INCOME SURVEY

ACTIVITIES ENGAGED IN
BY TYPE AND CONTROL

	4YR AND UNIVERSITIES		TWO YEAR		
	PUBLIC (n=45)	PRIVATE (n=73)	PUBLIC (n=65)	PRIVATE (n=12)	TOTAL (n=195)
1. FRANCHISING AGREEMENTS	2.2%	1.4%	0.0%	0.0%	1.0%
2. ADVERTISING	80.0	50.7	53.8	33.3	57.4
3. LICENSING OF INSTITUTIONAL LOGO/MEMORABILIA	35.6	9.6	0.0	0.0	11.8
4. PATENT AGREEMENTS	40.0	9.6	0.0	0.0	12.8
5. ROYALTY AGREEMENTS	35.6	16.4	7.7	8.3	17.4
6. SOFTWARE DEVELOPMENT AND SALES	22.2	8.2	4.6	8.3	10.3

ATTACHMENT B

nacubo report

Business Competition Issue Is Addressed by NACUBO

NACUBO Board Approves Business Activities Policy Statement, Guidelines

The NACUBO Board of Directors approved in principle a Policy Statement and Guidelines on Business Activities of Colleges and Universities at its March 20 meeting. The statement and guidelines were developed by the NACUBO Policy Task Force on Business Competition in February.

All NACUBO primary representatives will receive an exposure draft of the policy statement and guidelines this month (NACUBO *Special Action Report 87-3)*. Comments on the document are encouraged and will be considered prior to its final adoption.

In addition, comments on the policy statement and guidelines have been solicited from other higher education associations.

"The guidelines were written to aid college and university administrators as they prepare guidelines for their campuses," said William Erickson of San Diego State University, a member of the board and chairman of the task force.

Development of the general guidelines for colleges and universities is the first step in addressing the charges of "unfair competition" from the small business community, according to the task force.

Results of NACUBO Survey On Unrelated Business Income

The NACUBO Policy Task Force on Business Competition has completed its analysis of data gathered in a recent survey of college and university unrelated business income activities.

The results of the survey will be used by the task force to respond to charges by the small business community of "unfair" competition by higher education institutions and will be shared with the Oversight Subcommittee of the House Ways and Means Committee in the upcoming hearings on this issue.

Survey Methodology and Findings. NACUBO's Governmental Affairs Department mailed the unrelated business income survey in late December, 1986, to a stratified random sample of 481 institutions of higher education. Responses to the detailed questionnaire were received from 195 institutions (40 percent) and, with the exception of independent two-year colleges, were well distributed among the various types of institutions. The information received from this survey provided the task force with a more detailed picture of the services offered by colleges and universities, reporting and auditing of unrelated business income, and related issues.

The survey asked about 22 services that colleges and universities offer, when the services were begun and whether the college contracted for the service with an outside firm. The services most frequently offered were the traditional ones including food services, bookstores, student housing (at four-year institutions), and copying and duplicating services. A majority of institutions also provide rental of institutional facilities, including classrooms, conference and athletic facilities, and dormitory space during vacation periods, lecture series, concerts, and audio-visual services.

The period of greatest growth in the number of services offered appears to be between 1960 and 1975, also a period of great enrollment increases at colleges and universities. Although allegations have been made that institutions have been adding many services during the last decade in order to bolster revenues, services that have been added since 1975 are primarily those that reflect recent technological advances in areas such as computers and videotapes.

The provision of travel services (including alumni tours) and the establishment of summer camps have also increased by more than 50 percent over the last decade. The introduction of child care services, one of the few areas where independent four-year colleges and universities lag behind both public institutions and two-year colleges, was about evenly divided between the periods 1960-1974 and 1974 to the present. This would indicate that institutions began to enter this field before the current demand in the private sector, probably to facilitate enrollment of nontraditional students with children.

Sometimes institutions will contract with an outside firm to provide services to the campus community, an important consideration when the issue of unfair competition by nonprofits is raised. The NACUBO survey found varying degrees of contracting out among different types of services. Travel services were contracted out by 26 percent of the institutions that offered them, bookstore operations were contracted out by 17 percent (more than 97 percent of the sample had bookstores), and almost 60 percent of the institutions contracted out their restaurant/cafeteria functions. Alumni tours were contracted out by 12 percent of the respondents and broadcasting of athletic contests was contracted out by 37 percent.

The reporting of unrelated business income to the IRS and IRS enforcement of the regulations covering unrelated business income (as indicated by audits) were also covered by the survey. An IRS form 990-T is used to report unrelated business income by nonprofit corporations and to pay taxes owed. Independent four-year colleges and universities were much more likely to file 990-Ts than any other group of respondents to the survey. Thirty of the 37 institutions who reported filing 990-Ts with the IRS for 1985 were independent four-year colleges and universities. However, of the 34 institutions that supplied information about the amount of income reported, only 15 showed a profit on their unrelated activities.

Independent four-year colleges and universities were also more likely to be audited by the IRS for unrelated business income than other institutions. Nineteen percent (37 institutions) of the respondents have been audited; 29 of these were independent four-year colleges and universities. For the most part, institutions did not have problems or unfavorable outcomes from the audits. Only three reported any exceptions or disallowances and three said they were required to file 990-Ts. Twenty-four said that no problems had been found or that issues had been resolved in favor of the institution.

Only six institutions (3 percent) that answered the survey reported legal action was filed against them claiming "unfair competition." With the exception of one independent four-year college, all were public universities or four-year colleges. Two of the six institutions reported action that had taken place during the 1960s, making the number of recent cases very small. The services cited in the legal actions included bookstores, computer sales, hotel and conference facilities, travel, parking, and a copying center.

The task force felt that institutions should develop guidelines for their own use in evaluating their business activities. The survey results showed that very few have done so to date. Only 11 percent of responding institutions (21 institutions) indicated that policies or guidelines existed (and some of these were not formal or written policies).

Janet P. Jackley
Program Manager
Governmental Affairs

Anne C. Gross
Consultant
Governmental Affairs

NACUBO Representatives Meet with House Leader on Competition Issue

NACUBO representatives William Erickson and Bert Cofer met with House Majority Whip Tony Coelho (D-CA) to discuss college and university concerns regarding the unrelated business income issue.

The two business officers met with Coelho to ascertain the congressional perspective on the current unrelated business income law and the small business community's claims of "unfair competition from institutions of higher education." Erickson, chairman of the NACUBO Policy Task Force on Business Competition, is from San Diego State University; Cofer, a member of the task force, is from Yosemite Community College District.

Coelho is the third-ranking Democrat in the House, encouraged NACUBO to discuss with members of the Ways and Means Committee's Subcommittee on Oversight the importance of the unrelated business income law to colleges and universities.

Coelho applauded the NACUBO task force's efforts to develop a policy statement and guidelines for business activities of colleges and universities. Coelho encouraged NACUBO to share the guidelines with the Oversight Subcommittee at its upcoming hearings, which are scheduled for the end of this month.

Erickson and Cofer were pleased with the meeting with Coelho. "I felt that the meeting went very well," Erickson said. "Representative Coelho had a good understanding of the issue and the importance of the unrelated business income law for colleges and universities," he added.

"I was delighted with the encouragement Tony offered," Cofer said. Cofer, a constituent and personal friend of Coelho who arranged the meeting, encourages other administrators to contact their congressional representatives.

"Congress can't understand the importance of this issue to colleges and universities if we don't explain it to them," Cofer said.

Bert Cofer (left), House Majority Whip Tony Coelho (center), and William Erickson discuss unrelated business income issues at Coelho's Capitol building office. *Photo by Janet Jackley*

ATTACHMENT C

Policy Statement and Guidelines on Educational Business Activities of Colleges and Universities

Policy Statement

American higher education has a rich heritage of providing teaching, research, public service, and campus support. Since the passage of the Morrill Act, opportunities for higher education have been increasingly available to all members of our society.

More recently, the post-World War II G.I. Bill, the National Defense Education Act, and legislation providing Pell Grants have made access to higher education possible for even greater numbers of Americans. The rapid growth of higher education since the early 1960s has created a demand for facilities and services at institutions. In response, institutions have expanded services and facilities to meet the demands of diverse student populations.

Research conducted on campuses by university faculty members has helped fuel the rapid growth and development of technology that in turn has contributed significantly to the quality of life available to all Americans. Research begets new knowledge, and new knowledge stimulates additional research. Higher education has helped provide America with one of the world's most well-educated populations and with one of the highest standards of living in the world.

The requirement that higher education continue to enhance the quality of life, provide technological advancement, preserve a value for cultural arts, and be accessible to all members of society presents a unique set of circumstances. Higher education activities transcend a broad spectrum in response to the demands of society and make contributions to society that are virtually limitless. The end result is a dynamic higher education response to the many demands of society in a highly technical and rapidly changing environment.

Higher education recognizes that small businesses have become increasingly concerned about the involvement by institutions of higher education in activities and endeavors that are viewed by some as outside their mission. Unfortunately, the extent to which higher education is involved in such activities has been distorted, thereby exaggerating the impact of such endeavors on small business. Furthermore, there are current federal laws and regulations governing the educational business activities of institutions, and these laws and regulations are adequate to address the issues raised by the small business community.

To further assist colleges and universities to self-regulate their educational business activities, we have developed the "Policy Statement and Guidelines on Educational Business Activities of Colleges and Universities." It is our belief that this policy states clearly (1) our understanding about the concerns that have been expressed and (2) our firm commitment to ensure that our member institutions recognize their responsibility for implications of actions taken at their institutions when educational business activities are created and operated to serve their communities.

Guidelines

Education-Related Activities. The primary mission of [name of institution] is the creation and dissemination of knowledge. To carry out this mission, it is often desirable for the institution and its affiliated units to charge fees for providing goods and services that enhance, promote, or support its instructional, research, public service, and all other educational and support functions in order to meet the needs of the students, faculty, staff and members of the public participating in institutional events.

Educational business activities shall be established and carried on only when pursuant to, and in accordance with, an authorization and statement of purpose approved by the institution's governing board and/or chief executive officer.

Each educational business activity shall meet the following three conditions:

☐ The activity is deemed to be an integral part in the fulfillment of the institution's educational, research, public service, and campus support functions, and other educational and support activities, without regard to profit.

☐ The activity is needed to provide an integral good or service at a reasonable price, on reasonable terms, and at a convenient location and time.

☐ The activity is carried out for the primary benefit of the campus community but with sensitivity to the total community.

Unrelated Activities. The institution should comply with applicable laws and regulations pertaining to such activities, and educational business activities not falling within the guidelines established above may be unrelated business income activities.

NACUBO

One Dupont Circle • Suite 500
Washington, D. C. 20036-1178

FIRST CLASS
U.S. POSTAGE
PAID
Washington, D C
Permit No. 502

ATTACHMENT D

DRAFT

UNIVERSITY OF WASHINGTON POLICY
ON
SALES OF GOODS AND SERVICES

Introduction

The primary mission of the University is the creation and dissemination of knowledge. In carrying out this mission, it is often necessary for the University and its affiliated units to provide goods and services for fees which enhance, promote, or support its teaching, research, and public service functions. At the same time, the University must be mindful that when it provides goods and services for fees, it may be competing with local private businesses.

This policy has been developed to define the legitimate purposes under which sales of goods and services for fees may be approved, and to establish a mechanism to review such sales.

Policy

The University of Washington may engage in the direct sale of goods and services to individuals, groups, or external agencies for fees only when those services or goods are directly and substantially related to the educational mission of the University. Charges for goods and services shall be determined taking into account their full cost, including University overhead, as well as the competitive price of such items in the local community.

Exclusions

Recognizing that the central mission of the University is providing of instruction, research, and public service, this policy shall not apply to charges for instruction in its regular, extension, evening, or continuing education programs; services provided in the practicum aspects of its instructional and research programs; services for fees in its extracurricular or residential life programs, including residence halls, food services, athletic and recreational programs, and the performing arts programs.

Criteria

The sale of services to faculty, staff, students, and patients which are for the convenience of and in support of the broad educational mission of the University is distinctly different from sales to persons or organizations external to the University. Therefore, different criteria to evaluate requests for such programs are appropriate.

Criteria for Sales to Campus Community Members

Each of the following criteria shall be used in assessing the validity of providing a good or service to members of the campus community:

1. The good or service is substantially and directly related to the University's instructional, research, or service mission.

2. Provision of the good or service on campus represents a special convenience to and supports the campus community or facilitates the extracurricular, public service, or residential life of the campus community.

3. The price or fee for the goods or services is established at such a level as to account for full costs, including University overhead.

4. Procedures are in place for ensuring that the service is provided only to members of the campus holding valid identification.

Criteria for Sales to the External Community

The University shall not engage in any sales activities solely for the purpose of raising revenue to support an educational or research activity if the goods or services sold are not directly and substantially related to the educational program.

Each of the following criteria shall be used in assessing the validity of providing goods or services to the external community.

1. The good or service represents a resource which is directly related to a unit's educational mission, which is not commonly available or otherwise easily accessible, and for which there is a demand from the external community.

2. The price or fee of the good or service is established to account for the full costs of the good or service, including University overhead. The price of such items in the private marketplace shall be taken into account in establishing the price or fee.

Review and Approval Procedures

Approval for the sale of any good or service not excluded from this policy shall be vested in Deans and Vice Presidents for the units under their direct authority. Before any sales project may be implemented, the unit proposing the project shall provide to the Dean/Vice President a request setting forth all pertinent information about the sales plan, and justification for such program addressing the elements of this policy and stated evaluation criteria. The Dean or Vice President shall, if he/she approves the project, notify the Budget Office of said approval as a condition to the creation of a revenue budget, and provide the Budget Office with copies of the documentation supporting the request.

Each category of goods or services sold is to be considered individually so as to avoid the unplanned expansion of any sales program. All new categories of sales shall be justified to and reviewed by the Dean/Vice President in accord with this policy.

Oversight

The President shall designate an existing University office to be available to:

1. Resolve matters concerning the internal application of this Policy. It is the role of the Budget Office to review requests from Deans/Vice Presidents to establish revenue budgets. Should the Budget Office believe that the request is inconsistent with this Policy, it shall refer the matter to the designated office for final decision.

2. Address questions from members of the external community about specific sales programs.

3. Because sales of goods or services to other governmental agencies involve University-wide considerations, this office shall review all proposed sales to other governmental agencies.

Review of Existing Programs

As this policy is new, all current sales programs shall be evaluated by the Deans/Vice Presidents, following the procedure for initial review and approval stated above, not later than six months after the effective date of the adoption of this policy.

Office of the Provost
10/7/86

July 14, 1987

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Pickle:

During the presentation by the representatives of higher education at the hearing on June 25, 1987, all witnesses were asked to give their views on the recommendations of the Treasury Department concerning possible modifications of current law. Following my testimony Congressman Anthony invited further comments on the allocations of income and expense in Vanderbilt's collaborative agreement for the construction and operation of the Vanderbilt Child and Adolescent Psychiatric Hospital, allocation principles being the subject of one of the Treasury recommendations. Finally, witnesses were asked to provide information about any taxable subsidiaries at their institutions. I will comment on these three points, and am grateful to have the opportunity to provide additional information to the Subcommittee. With a copy of this letter, I am also transmitting to Robert Leonard, in response to his request, corrections on the hearing transcript.

First, in regard to the Treasury recommendations generally, a response is being developed by the American Council on Education that will address in detail points of interest to Vanderbilt. The following points deserve particular emphasis, and I also want to point out that the most notable elements in Treasury's recommendations are the need for more detailed reporting and the need for additional data before changes to current law are considered. The Internal Revenue Service is scheduled to begin a Taxpayer Compliance Measurement Program this fall. Since data are lacking in so many areas, I believe that the Subcommittee would benefit from the availability of such data before competing its analysis and preparing any recommendations.

Recommendations by the Treasury Department:

I. Substantial Relationship Test

I agree with the Treasury Department's conclusion that the current requirement of establishing a substantial relationship to an organization's exempt purpose has merit as the basis for exempting related activities from tax. It is a familiar standard that has proven itself capable of administration. It would be difficult to develop a standard that could be applied more easily and, if so, the important body of interpretation of the existing standard would be lost.

Vanderbilt has not experienced the "administrative and interpretative" problems to which Treasury refers. As noted in my testimony, Vanderbilt was audited in 1983. Our return, including Form 990-T, was accepted as filed. In compliance with the agent's instructions, more detailed reporting of Vanderbilt's unrelated business activities described in my oral testimony is now shown.

II. Convenience Exception to the "Substantially Related" Standard

There are important reasons to retain the convenience exception. At Vanderbilt, undergraduate students are required to live on campus and may live off campus only with special permission. The residential character of Vanderbilt is important to the quality of student life. The availability of minimal convenience services on campus is important and critical to the preservation of a residential lifestyle.

Despite the fact that Vanderbilt operates dining halls for students who choose to use them, at least 50 proprietary restaurants have chosen to locate in the immediate vicinity of our campus. These businesses are drawn to a competitive market created by Vanderbilt, and they compete successfully. Moreover, the small number of convenience items sold in the Vanderbilt bookstore are similarly sold, often at lower prices, by small businesses in our immediate vicinity. They, too, are competing successfully.

To the best of my recollection, no complaint has been made to me by any business in our immediate vicinity during the decade that I have been Vice Chancellor for University Relations and General Counsel. In advance of the Subcommittee hearings, however, a local newspaper article stated that a reporter had asked two bookstores whether they felt unfair competition with the Vanderbilt bookstore. One store, located several miles from the campus, responded affirmatively although no complaint has been made to the University. The other store, located but a few blocks from the campus in a location that it has occupied for many years, responded negatively.

At Vanderbilt, I do not believe that the convenience exception results in any unfairness to the profit sector, but the elimination of that exception would have a detrimental effect on the residential quality of student life, as well as our ability to meet the needs of patients in the Medical Center.

III. Passive Investment Income

Passive investment income should continue to be exempt in the case of public charities such as Vanderbilt. The royalty exclusion should be narrowed if, in fact, it is being used to circumvent the unrelated business income tax, but the royalty exclusion for passive income from intellectual property and mineral rights should be preserved to maintain the same footing as other sources of passive income.

IV. Research Activities

Research must continue to be exempt from taxation. The current statutory exemption does not define research, and the Subcommittee may wrestle with the difficulty of trying to distinguish between exempt versus taxable research.

I believe, however, that "research" is a word that is commonly used and understood in its application to the work of universities, and that the problems inherent in constructing a statutory definition will greatly outweigh the possibility of improved tax administration. Research at Vanderbilt and elsewhere includes careful search, examination, experimentation, and interpretation and publication of results leading to new or modified applications, theories, methods, and understandings.

Doubtless some facets of university research could sometimes be segregated and made to produce a profit. The overall conduct of research at universities such as Vanderbilt can never, however, be profitable because of the unpredictability of result. To narrow the definition of tax-exempt research would risk significant prejudice to university research programs that are working well. In fact, university-based basic and applied research is a wellspring from which flows the source of new knowledge to fuel the growth and development of the profit sector. It provides the basis for the future international competitiveness of the profit sector, and it should not, and must not, be constrained.

V. Joint Ventures

At the hearing, I described a partnership between Vanderbilt University and Hospital Corporation of America to build and operate the Vanderbilt Child and Adolescent Psychiatric Hospital. You and Congressman Anthony both raised questions about this partnership, and I responded to those questions at the hearing.

Vanderbilt's participation in this partnership was explicitly contingent upon the receipt by Vanderbilt of a favorable IRS revenue ruling and a determination that Vanderbilt's participation was consistent with its exempt purposes and that any resultant income would not be taxed as unrelated business income. The tax treatment follows the economic substance of the agreement between the parties in that HCA has provided all of the working capital and cash for construction of the facility. The contractual arrangements between HCA and Vanderbilt contain no special provisions with regard to the allocation of depreciation. If the partnership recognizes income in future years, there will be no preferential allocation for depreciation or other items.

In this connection, I quote two sentences from the revenue ruling dated April 9, 1984, in regard to this collaboration:

> "The allocation of the partnerships' income is proportionate to the investment of each partner, and the agreement provides for an allocation of losses that is equitable in view of all other financial arrangements in this instance . . . . A careful analysis of the partnership agreement, development agreement, and all affiliation agreements between the partners has been made and we conclude that they have been negotiated at arms-length." (emphasis added)

In response to Treasury's concern that current restrictions on partnership allocations between taxable and tax exempt partners may be inadequate to prevent certain types of abuse, the collaborative agreement between Vanderbilt and Hospital Corporation of America does not allow for an abuse of the sort that Treasury suggests might be possible. There are strong public policy reasons supporting collaborations of this nature, current law was effectively applied by the IRS in its approval approving this collaboration, and the collaboration represents mutually agreeable and beneficial cooperation, rather than competition, between the not-for-profit and profit sectors.

> Given the existence of Treasury regulations under Section 704 that became final at the end of 1985, relating to the concept of "substantial economic effect," it is not clear to me that the potential for abuse exists at the present time. The agreement between HCA and Vanderbilt meets the requirements of Section 704 as amended.

Lastly, I want to respond to the Subcommittee's request that each witness submit a list of any taxable subsidiaries at his institution. At Vanderbilt, we have one taxable subsidiary.

Mid-State Health Services, Inc. is owned by Vanderbilt and operates Progressive Health Care Group. Progressive is a certified home health agency which offers former patients of the Vanderbilt Hospital the assistance of experienced registered nurses; home health aides trained in personal care; skilled speech, physical and occupational therapists; and medical social workers.

In considering how best to provide a continuation of needed care to discharged patients of the Vanderbilt Hospital, both the option of starting a new home health organization and of acquiring an existing organization were considered. The most efficient approach, taking into account Vanderbilt's needs and the existence of home health organizations in our community, turned out to be the acquisition of an existing agency that was existing as a profit business. The agency is currently being operated by Vanderbilt at a loss, and because it is now serving only discharged Vanderbilt Hospital patients probably should qualify for tax exemption if restricted to not-for-profit status.

I will be pleased to discuss these matters further with you or members of the staff if that would be helpful.

Sincerely,

Jeff Carr
Vice Chancellor for
University Relations
and General Counsel

JC/sm

cc: Members of the Oversight Subcommittee
Mr. Robert Leonard

Mr. Anthony. I would like to just get a general overview of the thrust of what they think Treasury is attempting to do and whether or not they think Treasury is moving in the right direction, orally, today. Mr. Mason?

Mr. Mason. Well, I might start. My one remembrance of their testimony related to cost allocations and I found them to be ambivalent. There were some court cases that suggested this or that way would be appropriate and they disagreed with them. One of the issues which I think we have to keep in front of us is there has to be a degree of reasonableness in whatever we do. I am a former Internal Revenue agent myself and in years gone by, have done a lot of field auditing. I have always found from being on both sides of the fence, that the Internal Revenue Code can be interpreted in many, many ways. I think one has to take all the facts and circumstances, and with reasonable people, then one reaches a conclusion. My observation on Treasury trying to find a magic formula for cost allocations, there are many formulas for cost allocation, all of which have a basis or a sound basis and could be applicable in given circumstances. I think, reasonableness is one of the things that is missing in their approach.

On the related income, I have no disagreement with that. On the convenience, I think here again, one should also look at the facts and circumstances of the issue. They do that in every other case they audit, whether it is General Motors, or whether it is Chrysler, or whether it is the University of Notre Dame. They have various standards to apply to that given set of circumstances and all we would ask, is that when they come visit us, they also view us in the environment in which we live and in the area in which we operate. Therefore, that begs not for more regulations, but for taking what already exists and relating those on a reasonable basis and we did not have any trouble with the Internal Revenue Service.

Mr. Anthony. Mr. Mason, I think the problem is that there has been too much controversy over the regulations as they currently exist and to think that that is going to be the path of the future is folly. So I hope you do not come and leave thinking that the world is going to be the same as you found it. I think Mr. Schulze just put you on notice that after these 5 days of extensive hearings, I think the record is going to speak fairly loud and clear that there are going to have to be some changes.

The changes can be reasonable or unreasonable and I think that that is what he was suggesting and that is basically, Mr. Chairman, what I am suggesting, that we try to get as input back from you as possible as to what Treasury's recommendations are to us because I can tell you, they carry a great deal of weight because they will be the ones that will our eyes and our ears and our investigatory body in terms of whether or not there is any abuse out there.

Mr. Mason. The other important issue which I think the Treasury made is they felt, in a number of cases, that they lacked sufficient information to make concrete or solid recommendations.

Mr. Anthony. Well, let me just give you a prime example and rather than each panel orally talking about it, I think I would give you much better opportunity to get totally briefed on what the recommendations are and then you can get a much better opportunity to respond more specifically. Just a classic illustration, Mr. Carr, their seventh recommendation says respect to joint venture activities of exempt organizations, that is Vanderbilt and, I assume, the general partner that owned the land and the general partner that was created to be a 50/50 coequal manager of this psychiatric unit. It says that are concerned that current restrictions on partnership allocations between taxable, and now we are talking HCA, which I understand is headquartered in Nashville, TN, and tax-exempt partners may not be adequate to prevent abuses.

You just stated, in response to a question from the Chairman, that HCA gets 99 percent of all of the losses attributable, if there are losses. Now, I am going to tell you what. At first blush, without knowing anything else about it, I think that is an abuse. So you have an educational process on your hands to convince this member of Congress that that partnership was not set up in such a way that in the early years, where one would expect to have losses, that a taxable subsidiary is going to be able to absorb all of the losses. Therefore, they are going to be able to write off all of the costs and they are going to take it against their corporate income tax and that is going to cost the taxpayers money. That appears to be a case where both HCA and Vanderbilt need to educate us as to whether or not there was any abuse there.

When you look at Treasury's seventh recommendation, it appears that they may be heading into recommending that we take a look at those type of circumstances. So the issues are much more complex than we are going to be able to resolve today. I can tell you that this is what we are hearing from our constituents. I will not even go into pulling out the big chart that the travel agencies brought me about universities providing travel tours and they even make the allegation that you call them and get quotes and then you turn around and beat their quote. So there are lots of problems that you have and I think the more detailed information you can get us, then the more likely you are going to like the final output. So I will close there but if anybody wants to respond to anything I said, if the chairman would give you that permission, I would be glad to hear it.

Mr. CARR. Mr. Chairman, may I respond?

Chairman PICKLE. Yes, Mr. Carr.

Mr. CARR. There are no provisions in our partnership agreement with HCA that allocate depreciation. The partnership agreement is based on the economic value that flows to each party. Depreciation will follow that economic value.

Vanderbilt University was not in a position to pick up the early year operating losses for this hospital. Since HCA bears early year operating losses, the economic consequences, including depreciation, would flow to it.

When the hospital turns the corner—assuming it does—the income and depreciation will be allocated without regard to whether it is going to a taxable or tax-exempt entity.

So, from our point of view—and as I mentioned earlier, this stood the scrutiny of the Internal Revenue Service, applied for and received a ruling in advance—we have an arrangement that lets depreciation follow the true economic value.

Mr. ANTHONY. Mr. Chairman, just one quick comment.

Chairman PICKLE. Let me ask you to yield. Dr. Bruce, in your question about your operation of the Sheraton, that is a taxable subsidiary. Is it a controlled operation? Treasury has recommended as a test, that you own stock or interest in it in excess of—I mean, the current law is over 80 percent. Treasury is now recommending 50 percent.

Do you object to that, or what would be your reaction? That is the type of reaction I want to know, from those type of things. So you could comment on that, but I have been saying that as a general rule for all these recommendations.

Mr. BRUCE. My reaction, if I might, Congressman—and I would like to put it in writing—is we would not be in the hotel business if we did not have a school of hotel and restaurant management.

I mean, one did not get into that just to try to generate income.

Mr. DIBIAGGIO. Could I just, Mr. Chairman, make one last comment? I just reviewed these once again, and I thought perhaps I was missing something. These are kind of general recommendations which call for study, for exploring certain kinds of areas. We support that. We support that, totally.

We are as concerned, as you are, with having good relationships with the business community. The "town and gown" syndrome is an important one to us, as you can well appreciate, particularly when you live in a community in which you are a very vital part of that community, as we are.

And so, indeed, we will respond to each of these recommendations.

Chairman PICKLE. Dr. DiBiaggio, we do not question your intent and your purpose.

Mr. DIBIAGGIO. Yes.

Chairman PICKLE. We are trying to look at facts, now.

Mr. ANTHONY. Mr. Chairman, just give me that extra thirty seconds.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. I did not want my time to close without reinforcing just what the chairman said. Don't misinterpret anything that I said, to say that I do not agree with the hard challenge that you have, and the public purpose, and the good public purpose with which you are carrying out your activities.

But the fact is that we have a problem that has been brought to us. We are going to have to find out if it is deep enough to create any additional changes.

The first recommendation says "more reporting." Now most people go absolutely nuts when the Federal Government says they want to know more information, but sometimes the more information you have, then the better you can apply current standards or new standards.

So I would particularly like to know how cumbersome any additional reporting would be on your activities. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

For the record, I am on your side. I am still a tenured faculty member, but I am pretty disappointed in your performance today. Most of it reads like a graduate paper in education courses. I understand, Dr. DiBiaggio, that the diversity of the associations you represent, from community colleges who really do not have any research but are heavily involved in the community itself, offering various services, to some of the finest internationally known research universities.

I guess what my colleagues are trying to tell you, and I will tell you a little more bluntly, is that something is going to be done, and either you can help us to do it in a way that does not make your job more difficult, or we will do it anyway.

The kinds of things we cannot use are statements, for example—and I know, Mr. Mason, that this is not your statement but it is the statement of the College and University Business Officers' statement—pointing out to us the obvious, that colleges and universities have undergone radical changes and become increasingly complex. This is on page 2 of your testimony.

That they are a lot like a small city, et cetera. Well, all of the functions in a city are not municipally owned, and what you just argued earlier was the need to have them all municipally owned.

And when you tell us that, basically, the National Association of College and University Business Officers sincerely believes that if these activities are understood and viewed within the educational mission, and the current technological and economic environment, many concerns and misunderstandings will be resolved—there's no question, if we thought the way you did, there would not be any problem.

But that is not very helpful to us because there are a lot of people who do not think the way you think. When you reviewed the list of concerns you have had on your campuses, and you list bowling alleys, deluxe tennis facilities, movie theaters, and a whole host of items that have been presented to us, we do see a problem.

Now Dr. DiBiaggio, you talked about your student stores not selling cameras and stereo equipment, but rather, computers in the example of your testimony. Mr. Mason says, wait a minute, it is entirely possible that in pursuit of the educational activities of the university, you would sell cameras in a student store.

I would think so, if you had a course in photography, and you would sell photographic equipment as well. And does that then extend to the assumption that if you have in your business department a class on "Dress for Success", that you have an entire haberdashery there for people to try out the various clothes that they have?

It is obvious that the word "university" means just exactly what it is. You can go anywhere in terms of the pursuit of knowledge, and it is an appropriate application of the university's role in the system.

What we are trying to tell you is, that is not a very good answer. There are specific activities in which you have engaged in, in more recent years. You have very entrepreneurial type people that you have moved into business positions because you want them to be aggressive, and that you are carrying on activities that have caused other people to question what you are doing.

We are going to go through a process of drawing lines, either statutorily, or providing IRS with some very, very specific information for guidelines. What we really need out of you is not a "sell job" to indicate to us how important the universities are in a system.

All of us are dedicated to supporting universities. What we need from you folks are specific internal examinations of what you have been doing. Doesn't anyone feel a little bit guilty? Haven't there been sessions in which you have asked yourselves, golly, this may go a little farther—I mean, I guess I am that broad-minded to extend the role of the university to this.

These kinds of things have gone on. Share with us where you think the lines are, and where you have drawn them, with specific examples. What we will try to do is come back and talk about where we think that is probably a little too far stretched.

Please don't give us any more examples of computers being sold. I know Apple tried to get people—I mean, it is smart business sense for Apple to sell—not at a loss—but at a very small profit, to people who are going to be in the business of educating others.

And yes, they hit on a very brilliant business idea, and others have picked up on it, to provide the opportunity to sell at a substantial discount computers at student bookstores.

You then say it is sold only to students and faculty. Can you tell me that there is a positive way in which, for example, a student body card, an ID, has been punched, stamped, or permanently marked, so that student can buy only one computer?

Now that is simply not true. Has anyone questioned a student buying three computers, four computers? No, you do not question that. You, rather, point out that it is restricted only to students and faculty. I have a son in college, and I have a lot of friends who tell me what goes on today, and what a "great deal" they got. That is the problem that we are facing, whether it is for travel, whether it clothing, whether it is electronic devices.

I guess what I am trying to tell you is that you had an opportunity to work with us toward a reasonable conclusion to tighten up the rules and regulations in the law. You missed your opportunity at this particular occasion.

I want to give all of you an additional opportunity, especially your broad-based organizations. Get serious about you really want to do in terms of your university pursuits, and, if you do not, we will start requesting a simple printout from your business offices on everything you are engaged in, and then we will start drawing lines ourselves, relatively arbitrarily, perhaps unfairly.

That is why we are holding these hearings. We do not want to operate that way.

Mr. DiBiaggio. Well, Mr. Thomas, if I might respond. I think your statement is an accurate one. In 4 minutes one cannot cover an issue of this degree of complexity nor can one come to conclusions after a week of hearings.

One needs a great deal more information than you currently have at hand. Much of what you say is anecdotal. I contend, that under the current law, properly applied, as it was in our case with the filing of 990Ts, and with the Federal audit which occurred just this past year, we can identify those areas which are indeed unrelated.

And if our institutions are held to a standard, if the requirements are of a level of specificity, then, indeed, we can—and if we are compelled to keep the kinds of records that are necessary, then we can make responses to the kinds of accusations that are made, which I think, in some instances, are unwarranted.

And I know in our instance—and I can only speak for one institution—that indeed that is the case. The kind of thing that you talk about, I think I could clearly show at our institution does not occur. We do not sell the kinds of things that we talked about, and I would not even argue the case for cameras if we taught photography, because I think that those should be purchased elsewhere.

I talked about convenience items like toothpaste and such things, and I think you would agree with that.

Mr. THOMAS. Not necessarily. It depends upon circumstance, and you pointed that out as well. A lot of it is circumstances. But just let me conclude by saying you did not have just four minutes. You had 13 pages, and in fact you could have said what you wanted to say on 13 pages. My assumption is you did say what you wanted to say.

And what it is is basically platitudes in terms of support of the organizations. I understand that that is part of the necessary program.

What I am telling you is that you cannot tell me that all of these institutions and the 13 various associations are carrying on as precisely and properly as you are. Otherwise we would not be in this process.

Mr. DIBIAGGIO. Yes, sir.

Mr. THOMAS. A whitewash is not going to do you any good. What it is going to do is throw us on our own resources to try to determine how we are going to draw the line. I do not want to fall on our resources. I want as much input from you folks as possible, and, frankly, if your associations had been policing all of the member universities and colleges the way they should have, we would not be here today.

Because I want to underscore the point that almost all of the complaints that we have been getting have come from the university and college area, and that this is the area we are focusing on primarily. Perhaps other areas will be more enlightening as we go along, but for most of us, the complaints have come from this area.

To the degree you folks have been doing your job, if you can define it adequately, we would not be here. We are going to help you do your job in defining it. We want you to help us do our job in defining it as well.

Thank you very much.

Chairman PICKLE. I appreciate those very mild observations, Mr. Thomas. [Laughter.]

I must say to this panel, that we know that 4 minutes is a short time, but we all recognize that you have been advised of that limitation.

And I would observe that this is the first panel, we have not finished it yet, and I imagine the other five panels are wondering if they are going to get the same time you have, that you are taking all the time.

But time is a problem for us. I am going to ask all members to please try to stay within the 5-minute limitation so we can move along as quickly as we can.

The Chair would ask Mr. Flippo to take the Chair, and ask what questions you wish to at this point.

Mr. FLIPPO [presiding]. These questions of materiality I and essentially what we are all trying to deal with. We are trying to understand—and I believe, Mr. Mason, you really referred to the concept of materiality in—there is no way you can eliminate judgment, or the size of the problem. What we are really trying to determine, is how big a problem is it? How can we assess the materiality of the deviations from current law?

Does the gentleman from North Dakota have a question?

Mr. DORGAN. Mr. Chairman, in the interest of time I will not ask questions of this panel, but I would like to make the point, again, that we are dealing with an area here in which judgments are required to be made.

The question is what is "substantially related." That is not something that is measurable as easily as a dollar of income or a dollar of sales. This is a part of our tax law that requires judgment, and judgments are not always uniform. It is therefore difficult and confusing to judge, and I think that is why we are here today.

Any time you find something that allows for a judgment, it is almost certain that the opportunity for judgment will, in the long-term, allow the exception to define the rule.

There are some exceptions out there to this rule. At times Congress stops and asks, "What can we do to return to a more reasonable formula, and to one which conforms more to congressional intent?"

So that is why we are here. I am simply interested in what the panels have to say, so that we can craft a solution that is fair to everyone. Mr. Chairman, with that, let me defer my questions. I am anxious to hear the other panelists today.

Mr. FLIPPO. Thank you very much. Mr. Frenzel.

Mr. FRENZEL. Mr. Chairman, I want to thank the panel for its testimony. I think it has been advised, gently, by the subcommittee, as to some of the subcommittee's intentions. I would say that I am perhaps less aggressive than other members of the subcommittee in wanting to fix items which I am not sure are broken.

But clearly, we have revealed the little "cracks", we would like your help in dealing with them, and we will look forward to getting more of it in the future.

The exhortation that we had from Dr. DiBiaggio on examining these things case by case, and, from Mr. Mason, the former IRS agent—always glad to find one that has gone straight—that we have to consider the facts and circumstances—leads me to believe that all of you are going to be in a game that is going to be providing a lot more information in the future than you have provided in the past.

And that is probably all right because universities are supposed to teach orderliness of mind and orderliness of bookkeeping, and so it probably will not be too much of a burden.

Mr. Chairman, I thank the panel, and I yield.

Mr. FLIPPO. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

I suspect that the committee will not be going too deeply into the unrelated businesses that are taxed, but Mr. Bruce, you indicated you would not be in the hotel business if it were not for your courses in hotel management?

Mr. **Bruce**. That is correct, sir.

Mr. **Rangel**. How long have you run the hotel?

Mr. **Bruce**. Since 1982, the same year that we began the baccalaureate program in hotel and restaurant management.

Mr. **Rangel**. And how many rooms are in the hotel?

Mr. **Bruce**. 154 rooms.

Mr. **Rangel**. And how many students are in your program?

Mr. **Bruce**. Approximately 450 right now.

Mr. **Rangel**. And when you acquired it, where did you get the money to buy the hotel?

Mr. **Bruce**. It came through the university's endowment.

Mr. **Rangel**. And who runs the hotel? Is there an interchangeable board of directors? Are there people that work for the university, that work for the hotel?

Mr. **Bruce**. The directors of the hotel are a separate group of directors. They are university persons that serve as the directors of the hotel.

But the hotel is run as a commercial operation just as any other hotel is in the—my comments are about we would not have been in the business—it would never have dawned on us to buy a hotel if we did not have a program.

Mr. **Rangel**. Believe me, I am not questioning your intent or whether or not Mr. Mason's television studios are related to the university system.

It is just that it just does not sound as though you do not have an unfair advantage over those people in the community who would like to get involved in the hotel business, notwithstanding the fact that somehow it is related to a course that you have.

It is just difficult for me to understand—and I do not know enough about the subject—as to how you can get involved in an unrelated business merely because you have two or 300 students.

I mean, if what you are saying would logically follow, then law schools would operate law offices, and, you know, public science departments would be involved in running people's campaigns, you know, for money.

In any event, you do not see it as an unfair advantage, to take tax-exempt money and to buy a hotel, and to have people operate the hotel without fear of answering to stockholders, that in the same community, if I was operating the Hilton in your neighborhood?

Mr. **Bruce**. I do not see any conflict because——

Mr. **Rangel**. I did not say conflict.

Mr. **Bruce**. I do not see an unfair competition. As a matter of fact, we probably make less money in the hotel than the Hilton because we run it in a much richer fashion because it is part of an educational program.

Mr. **Rangel**. Well, I guess that is my point, Mr. Bruce. The fact that you make less money means that making money is not your goal.

Mr. **Bruce**. We do not—at this point we are not showing any money being made on it, at this point. I mean, I can understand the point you are trying to make, sir, but——

Mr. **Rangel**. You know, if I have to make money, and you do not have to make money, you could do a lot of things that I cannot do, as your competitor. Mr. Mason, is your television station in connection with courses that are being operated in the schools?

Mr. **Mason**. Yes. It was initially started 30 years ago as part of the educational process. We do have classes at the station.

Mr. **Rangel**. You acquired it as an educational function?

Mr. **Mason**. That was the basic mission, yes.

Mr. **Rangel**. Well, someone else on the panel asked, but, what courses do you have that you could not acquire a business in order to support whatever you are teaching? I just cannot figure it. There is nothing in the world, that if you are teaching, that you could not buy a business and get the board of directors to use tax-exempt money, buy the business, get some faculty member that is not shaping up, put him in charge of the business, and have non-union-volunteer help, and you make money you make it, you do not make it, we keep on moving.

I think it is an unfair advantage. I would hate to have to compete against you with the way you acquire and operate these things, and I suspect that there is a lot of benefit that goes to the students, but having worked as a hotel clerk when I was in school, I assume that there would be plenty of opportunities for the students to get jobs with people that acquired businesses the old-fashioned way.

But you may have a better answer, and we will probably look and see just how many businesses are involved, even though they are paying taxes. The idea is for you to make a profit, Mr. Bruce, so that we can charge the taxes and get on with the people's business.

But if that is not one of your goals, it is a little difficult for me to consider it as an educational project.

I yield back, Mr. Chairman.

Mr. **Flippo**. Thank you very much.

Gentlemen, we do appreciate your testimony, and thank you for being with us today.

Our second panel for the day involving nonprofit research areas. We would ask that our second panel assume their places at the table.

We have Dr. Joseph Saloom, a member of the board of directors of the Council on Research and Technology.

We have Mr. Robert Allen, the director of the Audio-Visual Services for the Consortium of University Film Centers. And we have Mr. Mark Richie who is the president of the National Association of Regional Media Centers.

If you gentlemen would please come to the table.

Dr. Saloom, would you please bring your testimony, and we are pleased to have you with us today.

STATEMENT OF JOSEPH A. SALOOM, PH.D., CHAIRMAN, COUNCIL ON RESEARCH AND TECHNOLOGY [CORETECH]

Mr. **Saloom**. Thank you. My name is Joe Saloom, and I am a senior vice president of M/A-Com Corp., in Burlington, Mass.

Mr. **Flippo**. Would the gentlemen suspend. We must ask our guests to please find seats, so that we might hear the testimony of our distinguished witnesses today.

You may proceed, Doctor.

Mr. **Saloom**. I am also the chairman of the Council on Research and Technology. CORETECH is the name of that. CORETECH is 139 university and corporate members linking the interests of the corporate and the academic communities, and this unrelated business income issue goes to the very heart of why CORETECH was formed.

It underscores the central importance of research and international competitiveness, and the critical importance of a cooperative research relationship between companies and universities.

This unrelated business income issue raises three important questions about the role universities play in research. The first is, is research a central and integral part of the purpose of universities? In the United States, the answer is a resounding yes.

The short explanation to this answer is that America's preeminence in science is due, in a very large part, to this unique and hospitable role that universities play in research and research training.

The second question raised by the unrelated business income issue is, are American corporations and universities in a complementary relationship, and what does that mean for our country?

The answer is that the relationship between companies and universities in research is overwhelmingly complementary, and a complementary relationship is key, we believe, to economic growth.

Many, including CORETECH members, believe that by strengthening the ties between campus and company researchers, we will be accelerating the process whereby scientific breakthroughs achieved in university laboratories will be more quickly translated into new commercial products and processes.

The key to future competitiveness will lie, to a much greater extent than ever before, in how well and how quickly we make that leap from basic research to commercialization.

The third question raised by the unrelated business income issue is, how do universities foster their role as complementary to, rather than competitive with, American corporations?

The answer, in the research area, is that universities have established internal policies which insure that research results are widely disseminated, and that their faculty members do not use their influence and access within the university for personal gain.

Under current law, scientific research is directly related to the tax-exempt purpose of universities. Development of specific products is not. That is the issue that was raised earlier.

The proper solution to this problem in interpreting individual factual situations, however, is not a radical change to the current treatment of scientific research. Rather, the proper solution lies with carefully examining individually cited cases of improper characterization to better administer existing law.

It seems to me, that when we have a law, and it is indeed abused or broken, I do not think we need new laws. I think in those cases, you put them in the pokey, and proceed to enforce what laws you have, rather than new ones. We feel it is that way in research.

In conclusion, let me state that, to us, this group of corporations and universities, this Council on Research and Technology, it is not a "white hat" versus a "black hat" issue, with industry pitted against universities.

When it comes to research, we all wear "white hats" and the relationship is indeed complementary.

I want to thank you very much in terms of some of the questions you have raised. If you have any question in terms of the understanding of testing, on page 12 of my testimony we discuss that issue in detail.

Thank you very much.

[The statement of Mr. Saloom follows:]

TESTIMONY BEFORE THE OVERSIGHT COMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE
ON BEHALF OF
THE COUNCIL ON RESEARCH AND TECHNOLOGY

June 25, 1987

On behalf of the Council on Research and Technology, or CORETECH, we are very pleased to be able to testify here today.

CORETECH was formed to link the interests of the corporate and academic research communities. To date, CORETECH includes 73 universities, 37 corporations, 6 research institutes, 16 associations, and 6 affiliates for a current membership of 138. We are still growing.

The unrelated business income issue goes to the very heart of why CORETECH was formed. It underscores the central importance of research and international competitiveness, the central importance of university research, and the critical importance of a cooperative research relationship between companies and universities.

The Role of University Research

The unrelated business income issue raises three important questions about the role universities play in research. The first is: Is research a central and integral part of the purpose of universities?

In the United States, the answer is a resounding yes.

Since World War II, American universities have proven themselves to be ideally suited to perform advanced research. Our universities are charged with producing two of our most precious resources: skilled and talented people and new ideas.

America's preeminence in science is due in very large part to the hospitable role universities play in research and research training. It is no accident that the phenomenal period of economic growth that occurred since World War II coincided with the rise of research universities. Economists are now saying that about half of all productivity growth achieved during this post-war period was due to technological innovation. Innovation can be directly traced to scientific research.

Prior to the surge in federal funding for university research that began in the late 1940's and early 1950's and accelerated after Sputnik, the United States did not have a commanding lead in science. For example, from 1901 to 1941, the first 40 years of Nobel prizes, only 17 Americans received these awards for science. In the four decades following World War II, Americans received 117 Nobel prizes in science. In 1986, over half the science awards went to Americans.

There are undoubtedly many reasons why U.S. scientists have excelled in the second part of this century. Chief among them has to be the unique coupling of research and advanced study that American universities foster. Over half of our basic research is now conducted in universities.

The Complementary Relationship Between Universities And Industry In Research

The second question raised by the unrelated business income issue is: Are American corporations and universities in a complementary research relationship and what does that mean for our country? The answer is that the relationship between companies and universities in research is overwhelmingly complementary. And the complementary relationship is key to economic growth.

One need only to look at the resurgence of New England's economy to see how a complementary company/university relationship works within the context of a regional economy. Studies have demonstrated that the area's resilience was due, to a very great extent, to its outstanding universities. Far from being in competition, these universities with their heavy emphasis on research, have proven to be a veritable spawning ground for new endeavors. New England's experience, I might add, has been replicated around the country, notably in the Silicon Valley in California, in Austin, Texas, and Research Triangle, North Carolina.

Steven Muller, President of Johns Hopkins University, has characterized this relationship as follows:

> The essential linkage between the universities and industrial innovation and vitality consists of people-related research as opposed to product-related research. The article of faith within the university community which insists on the inseparability of research and teaching is not merely sacrosanct . . . it is practical wisdom as well . . . To a large degree, the quality of government and industry in an age of technology is determined by the quality of available talent . . .

Corporations must almost always invest most of their scarce research dollars in product development. When more fundamental lines of inquiry are required, companies are increasingly turning to universities. Very few U.S. corporations have the resources to carry out their own, long-term basic or applied research. Dr. Chu's work on superconductivity at the University of Houston, for example, has, to date, spanned 14 years.

The complementary relationship that has evolved between academic and company research communities is now recognized and encouraged by the basic research credit adopted by this Committee and Congress last year. You are to be commended for encouraging closer collaboration between universities and companies in scientific research efforts.

Many, including CORETECH members, believe that by strengthening ties between campus and company researchers, we will be accelerating the process whereby scientific breakthroughs achieved in university laboratories will more quickly be translated into new commercial products and processes. The key to future competitiveness will lie, to a much greater extent than ever before, in how well and how quickly we are able to make the leap from basic research to commercialization. In the recent past, we have witnessed a series of new discoveries by U.S. scientists become successful products for our competitors, such as many consumer electronic products. In the 1960's and 1970's the university/industry research relationship suffered and we are paying a high price now in terms of lagging productivity growth.

We must safeguard our current investment in university basic research as well as foster universities' complementary role to corporate R&D to remain competitive in our changing world economy.

To that end, CORETECH agrees wholeheartedly with the central finding of the White House Science Council: "Our universities today simply cannot respond to society's expectations for them or discharge their natural responsibilities in research and education without substantially increased support". Some of that increased support will come from industry. But the federal government remains the predominant source of funds for basic research and support of university research programs.

In a very real sense, public policy today needs to make up for neglect. For too many years, the federal government has sent a negative message to its universities on research. A few statistics show what has happened:

1. Federal support for university research infrastructure fell 95% in real terms over the past two decades. It is now widely recognized that these facilities are all too often obsolete, inadequate, or inappropriate for advanced research.

2. Federal financial aid for university research showed virtually no growth in the 1970's. In the 1980's, although federal support of university basic research has been rising in dollar terms, as a percentage of U.S. spending in research, it is falling steadily.

3. There were no federal incentives to encourage corporate support of university research until very recently. Now as a result of these federal initiatives, the university/company research relationship has begun to expand. Closer campus/company ties on research not only have the benefit of speeding the commercialization process, they also provide vital training opportunities for graduate students on state-of-the-art research that will lead to tomorrow's products.

The Role Of Universities

The third question raised by the unrelated business income issue is: How do universities foster their role as complementary to, rather than competitive with, American corporations? The answer is that--for their own integrity and to comply with the requirements of their tax-exempt status--universities have established internal policies which insure that research results are widely disseminated and licensed in "arms-length" transactions and that faculty members do not use their influence and access within the university for personal gain.

Universities understand that knowledge is the primary product of the research. Knowledge--as a marketable commodity--is unique because its value is unknown to the user until it is revealed. Once that knowledge is revealed, however, it is easily duplicated, difficult to protect and therefore commands an artificially low market price. Thus, universities--dedicated to the advancement of knowledge and the education of students--see their role as creators of this information which, as published, may lead to more inventions, innovations, and economic growth.

Because the social returns which result from conducting research are greatest where the resulting knowledge and information are widely disseminated, universities generally have established policies dealing with publication rights in sponsored research. Particular policies of universities may vary slightly in terms of degree; however, all are premised on the notion that the university must be free to publish research results subject to some time-limited, pre-publication delay. Publication may be delayed to assure that the publication does not compromise any patent rights or trade secrets. Thus, the publication policies related to sponsored research foster the combination of efforts needed to advance the body of scientific knowledge, on the one hand, without extracting an unacceptable cost from research sponsors, on the other.

Stanford University provides a typical example of the kinds of established university policies that assure the dissemination of research information and results. Stanford's recently revised "University's Policy Guidelines on Secrecy in Research" states that freedom of access to information is a principal of overriding importance in university research. Thus, Stanford's policies preclude the University from engaging in a program of research which would require secrecy. Moreover, the University permits a delay in publication only so long as there is no basis to believe that the sponsor will attempt to either suppress publication or impose "substantive changes" to the publication materials. Thus, even Stanford's pre-publication delay privilege is carefully guarded to assure that the University's primary aim--the advancement of knowledge and the education of students--is furthered.

Other major research universities such as Harvard, Princeton, Vanderbilt, and Northwestern Universities, as well as the University of Illinois, University of Michigan, University of Alabama, and North Carolina State University similarly adhere to strict academic standards and goals when entering into sponsored research projects.

Universities also have policies relating to the licensing of research results with research sponsors. Licensing agreements are primarily entered into to insure quick development of the research results; however, they are also entered into to insure that the university receives a fair return. The agreements between universities and research sponsors are "arms-length" transactions and, by no means, constitute "sweetheart deals". Thus, the universities' policies on licensing agreement insures its complementary role with all American companies rather than as complementary to some but competitive with others.

Finally, universities generally have policies dealing with faculty outside work arrangements which often present conflicts of interest where a faculty member uses influence within the university to advance his or her own personal gain. Thus, for example, universities generally prohibit more than a nominal use of university facilities and services and often require reimbursement arrangements between the faculty member and the university in the event the faculty member uses university facilities and services in the course of the resulting activity. In addition, universities generally scrutinize faculty equity and work relationships with companies with which it expects to license research results.

In sum, it is CORETECH's view that current university policies adequately secure its role as complementary to corporate R&D by maximizing the social returns which result from conducting research.

Current Law And Unrelated Business Income

Universities, in performing and publishing the results from scientific research, contribute to a pool of scientific knowledge which can be used by the private sector in commercial product development. Scientific research includes both the original investigation for the advancement of basic scientific knowledge and the application of this basic scientific knowledge to create new ideas and processes; it does not involve the development of commercial products. Development of commercial products, in contrast, involves the translation of research findings or other knowledge into a plan or design for a new or improved product, process, or service. Scientific research is directly related to the tax-exempt purposes of universities.

While the distinction between scientific research and product development may be conceptually clear, when applied to a specific factual situation, the line distinguishing the two can become blurred. Thus, it would not be surprising if individual cases have arisen in which university activities were incorrectly characterized.

The proper solution to this problem in interpreting individual factual situations, however, is not a radical change to the current treatment of research as a proper tax-exempt activity of universities. Rather, the proper solution lies with carefully examining cited cases of improper characterizations to better administer the existing line.

Cases in a few common areas have most often been discussed as potentially presenting problems. The area of testing activities has been often mentioned in these discussions.

Testing

Aside from testing activities conducted as a way to provide clinical experience for students, under present law there are only two ways in which income from testing activities will be tax-exempt. First, where the actual testing activity is part of the greater research project, the activity will be tax-exempt. Research activities necessarily involve the experimental process by which a theory is devised, tested, and then retested as part of an effort to prove or disprove that particular theory. Thus, testing, as part of this greater research endeavor, would include testing of a drug in order to determine its effect on a particular indication, but not testing of that drug to determine if its quality is consistent for marketing purposes. The second way in which income from testing activities will be tax-exempt occurs where the testing is performed "for public safety purposes" and not for commercial purposes. This distinction would make exempt income from voluntary testing of products to increase consumer awareness, but not testing to obtain required regulatory approval of a pre-market product.

As these examples should indicate, the legal principles and guidelines of present law are generally satisfactory to determine what testing activities are properly a part of research. But the principles and guidelines must be stated clearly and applied carefully by the IRS to assure that some activities do not go beyond permissible bounds.

Testing in the Medical Setting

A related issue arises with hospitals that offer services such as blood testing to non-patients. As in the general testing area, where these non-patient services are undertaken to further medical research, they are directly serving the exempt purposes of the hospital or universities. Where, in contrast, the purpose of these services is to routinely check for disease as part of an effort unrelated to research, they are not necessarily serving any exempt research purposes and the merits of these activities should be analyzed apart from the research exclusion to determine whether they are "substantially related" to the exempt purposes of the university or hospital.

Applied Research

Besides the areas such as testing that require drawing a line between research and product development, some have argued that applied research should be considered unrelated to the tax-exempt purposes of universities. Applied research is an often misunderstood term. It is properly defined as research which applies basic scientific principles to create new ideas and processes, but not the development of specific products. Applied research under this definition is extremely important. If the United States is now at a weak point in its competitive capabilities, a major cause is the small amount of currently conducted applied research. Universities tend to focus more on basic research while private companies--eager to quickly turn development dollars into profit--focus almost exclusively on product development. Thus, notwithstanding the possibility of isolated competition in this area, university conducted applied research is consistent with and even crucial to the overall model of university research as the research and technology springboard for corporate product development.

It is possible that other specific research-related issues exist. If so, we would be interested in discussing them with you. We believe it likely that any issue can be resolved, within the scope of the present law exclusion for research, without undermining the basic concept that university research is fundamental to the proper purposes of our universities and complements rather than competes with corporate R&D activities.

Conclusion

CORETECH views the present law exclusion for research to be necessary and important to the crucial role university research plays in fostering corporate R&D activities. This basic model must be continued and indeed encouraged if this country is to remain competitive in a changing world economy.

What we do today will determine how well we can compete in the near future. Our investments in research and development will enable us to make the kinds of technological strides necessary to meet global competition. As the breakthroughs on superconductivity reveal, we are not just in a race to discover, but we are in a race to apply what we have learned. The complementary university and corporate research activities are the best tools we have now to accomplish successful commercialization.

Congress needs to be aware that research is both integral to universities, and university research is vital to corporations and to our society. It is also fragile. Years of neglect and stagnant or declining support have brought the university research community to this point. We are hopeful that by working together we can convince Congress to send U.S. research a positive message. This Committee, we hope, will do that by reaffirming the present law exclusion for university research.

Mr. FLIPPO. Thank you. Mr. Allen, we would like to ask you to present your testimony at this time and we will allow all the panel to present their remains before we go to questions.

STATEMENT OF ROBERT L. ALLEN, DIRECTOR, AUDIO-VISUAL SERVICES, PENNSYLVANIA STATE UNIVERSITY, REPRESENTING THE CONSORTIUM OF UNIVERSITY FILM CENTERS

Mr. ALLEN. Thank you, Mr. Chairman. I am Robert Allen, director of Audio-Visual Services at the Pennsylvania State University. I am here today representing the Consortium of University Film Centers, which is an organization of the audio-visual departments of 65 public and private universities which have, as their common interest, the operation of revenue producing, education film and video rental libraries. In addition to these 65 institutional members, the Consortium also has a membership of 40 film and video producers, distributors and other private for-profit companies, all of which have an interest in the distribution of educational materials.

The consortium is interested in making certain that the committee recognizes that all revenue producing activities of non-profit organizations, are not necessarily unfair competition, nor should all income be considered as unrelated income. The members wish to address only the role of the educational film rental library as it relates to these two issues.

The work of the member institutions of the consortium is part of the distribution system which begins with the production and includes the for-profit distributor and also services provided by schools and colleges. The first university rental libraries began to appear at various locations between 1910 and 1920. Typically, the land grant university within a State began to include, as part of the service activities of agricultural extension, the circulation of various types of teaching aids. The university film libraries provided then, and continue to provide, quality instructional materials to their own institution and at affordable rates to all school districts and other institutions of higher education, to support their teaching programs.

The distribution of these films, and more recently video tapes, is considered to be directly related to the purpose of the university. As such, no institution, to the best of my knowledge, pays any income tax on income earned by the rental libraries in that this income is not viewed as unrelated business income.

About two-thirds of the institutional members of CUFC responded to a survey of business data. This survey showed that the average income of the institutional members is less than $170,000 per year for a total of less than $7.5 million per year among the 44 institutions.

In a separate statement submitted to this committee, the president of the Association for Information Media and Equipment, Joseph Elliott, said in part, "the members of the Consortium of University Film Centers, while operating as not-for-profit agencies, do serve the companies which produce educational film and video. CUFC member schools buy products at retail prices from producing companies and rent those products to schools and colleges. The purchases of CUFC schools enable film companies to continue production by contributing the overall health and profitability of the companies. CUFC services have evolved from a need which the companies decided not to fill." He went on to say that the Consortium rental libraries "are an important link in our distribution chain and contribute to the overall vitality of an industry which serves the educational needs of our Nation's youth."

As your committee defines what is unfair competition and what is unrelated income and develops methods of addressing areas of concern, the members of the Consortium of University Film Centers urges the committee to recognize the vital and noncompetitive nature of university rental libraries. Both the university members and the producer/distributor members of the organization, are concerned that in correcting any genuine unfair competition practices, that nothing be done to prevent the continuation of services provided by university film/video rental libraries for more than half a century. Thank you, Mr. Chairman.

[Attachments to the prepared statement follow:]

AIME

Association for Information Media and Equipment
108 Wilmot Road 5th Floor Deerfield, IL 60015

MEMORANDUM

DATE: JUNE 3, 1987

TO: WHOM IT MAY CONCERN

FROM: JOSEPH ELLIOTT

Private sector businesses are increasingly vocal about the intrusion of not-for-profit agencies into almost every business sector. Certainly not-for-profits enjoy competitive advantages while contributing little or no tax base support to our society. Educational film and video companies have competed for many years against companies such as Great Plains National Television, Agency for Instructional Television, and The National Geographic Society. These organizations do not contribute any product to our industry that could not be produced by a tax paying, for-profit company. The reason for existence can be linked to the few individuals or organizations which benefit from the revenues they generate.

By the same token, the members of the Consortium of University Film Centers, while operating as not-for-profit agencies do serve the companies which produce educational film and video. CUFC member schools buy product at retail prices from producing companies and rent those products to schools and colleges. The purchases of CUFC schools enable film companies to continue production by contributing to the overall health and profitability of those companies. CUFC services have evolved from a need which the companies decided not to fill.

While AIME and its member companies object to the unfair competition of GPN, AIT, and National Geographic, the same cannot be said of the CUFC schools. They are an important link in our distribution chain, and contribute to the overall vitality of an industry which serves the educational needs of our nation's youth.

JEE:ak

BOARD OF DIRECTORS

President
Joe Elliott
Coronet/MTI Film & Video
108 Wilmot Road
Deerfield, IL 60015
312/940-1260

Treasurer
Ray L. Short, Jr.
RTI, Research Technology
International Company
4700 Chase Avenue
Lincolnwood, IL 60646
312/677-3000

Secretary
Franklin J. Visco
Lucerne Films Inc.
37 Ground Pine Road
Morris Plains, NJ 07950
201/538-1401

Richard P. Boehning
Walt Disney Educational Media
500 South Buena Vista Street
Burbank, CA 91521
818/840-1111

Robert L. Glore
Churchill Films
662 North Robertson Blvd.
Los Angeles, CA 90069
213/657-5110

CONSORTIUM OF UNIVERSITY FILM CENTERS
Executive Office
Audio Visual Services
Kent, OH 44242

June 4, 1987

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Attention: John Salmon

The Consortium of University Film Centers (CUFC) is an organization of 65 active institutional members, all of which are either public or private colleges or universities in the U.S. and Canada. In addition, there are 11 associate members and 40 sustaining members of the Consortium. This latter group includes almost all of the major private for-profit film/video distributors.

The common area of interest of all these members is the circulation of educational films/videotapes to public schools, colleges and universities, and other groups and organizations involved in educational activities. The institutional members operate film/video rental services as all or a major part of their function within their college or university. The total film/video resources of the institutional members are more than 210,000 individual titles and in excess of 270,000 prints of these titles. The latest circulation figures show that more than 400,000 films and videos were rented by the members of the Consortium. In addition, 250,000 were circulated by the members within their own institutions.

The members of CUFC wish to address only the role of educational film rental libraries as it relates to the issue of unfair competition. No attempt is intended nor should any be implied that this statement deals with the total range of issues involved in defining the broader problems of unfair competition. The Consortium as an organization does not have the information needed to comment on these broader issues being considered. It is felt, however, that CUFC would be remiss if this paper did not explain in some detail the function performed by the university film rental libraries.

Educational films/videos reach the classroom through a variety of channels. The most effective distribution would be to have a complete collection of all materials needed available on demand within the building where the teaching is taking place. In this way a faculty person would be able to use these materials at the moment most appropriate in the teaching/learning process. The economics and the concerns of the care and handling of film and video make this ideal situation out of the reach of virtually all educational institutions.

School districts may either develop their own film/video collections, be part of a multidistrict service supported by the local districts, and/or rent from university rental libraries. The teacher estimates when an individual film will be needed, enters an order to have it delivered on the day needed, and then returns the film immediately after use. This service, whether performed by the local district, by the multidistrict service, or the university rental library, is part of the distribution function.

Similarly, in colleges and universities some departments purchase film/video materials which are used directly in the instructional program at the department. Many colleges also have central collections which are available to all departments within the institution. In some instances, several institutions share the resources in their central collections, using a scheduling and delivery system similar to those used by the schools.

In both the schools and the colleges, the overwhelming majority of the films/videos available are purchased from private for-profit companies, or from individuals who have produced the materials for use in educational programs or who are acting as distributors of the materials. In this latter category are materials produced for another market, but which have some potential as educational materials - films/videos produced for television broadcast is the most common example.

These distribution patterns have and continue to supply the bulk of film/video services to schools and colleges in the U.S. However, no school district, multidistrict service, or college can afford to own all the materials available. The economics of acquisition demand that all materials purchased be usable by a large number of faculty and students. The only way to provide access to the materials that will only be used once or twice a year is to have a distribution function which serves a large enough population of faculty so as to generate enough use to justify the original purchase.

This is the role that the university film/video rental library plays in the distribution function. The first university rental libraries began to appear at various locations between 1910 and 1920. Typically, the land-grant university within a state began to include, as part of the service activities of Agricultural Extension, the circulation of various types of teaching aids. This need was recognized because of the growth of audiovisual departments in a number of large city school systems. The university film libraries provided quality instructional materials at affordable rates to all school districts to support their teaching programs. The cost of purchase was often found to be prohibitive for the smaller school districts. Many film producers and distributors have from the beginning played an active role in the development of these rental libraries. The rental libraries purchase films/videos from these companies with the understanding that the films/videos will be re-rented. These companies believe that they can be more profitable by selling their product to the university rental library than they can be by offering the rental service themselves. Frequently, these companies develop special marketing programs designed to encourage the rental libraries to purchase and re-rent their educational materials.

The sustaining members of the Consortium of University Film Centers represent companies which have taken an active partnership role in the development of what they recognize as an essential element in the total distribution of educational film and video. These companies not only pay their CUFC dues, but are eligible to become active members of the Board of Directors and serve on all commmittees of CUFC. This level of involvement is further recognition of the importance of the university rental library in the use of educational films/videos.

It should also be noted that all items purchased by university rental libraries are purchased with the full understanding on the part of the producer/distributor that the films/videos will be re-rented. A small number of companies either do not grant re-rental rights or charge a premium above the normal purchase price for these rights. This total control of rights by the producer/distributor is further evidence that the university rental library is a vital link in the distribution system rather than constituting unfair competition in any way.

As your committee defines what is unfair competition and develops methods of addressing areas of concern, the members of CUFC urge the committee to recognize the vital and noncompetitive nature of university rental library services. Both the university members and the producer/distributor members of CUFC are concerned that in correcting any genuine unfair competition practices the legislation not at the same time prevent the continuation of services provided by university film rental libraries for more than half a century.

Beverly Teach, President
Consortium of University Film Centers
Indiana University
Audio-Visual Center
Bloomington, IN 47405

John Kerstetter, Executive Director
Consortium of University Film Centers
Kent State University
Audio Visual Services
330 University Library
Kent, OH 44242

Robert L. Allen, Past President
Consortium of University Film Centers
Penn State
Audio-Visual Services
206 Special Services Building
University Park, PA 16802

Mr. FLIPPO. Thank you, Mr. Allen. Mr. Richie?

STATEMENT OF MARK L. RICHIE, PRESIDENT, NATIONAL ASSOCIATION OF REGIONAL MEDIA CENTERS

Mr. RICHIE. Thank you. My name is Mark Richie. I am the president of the National Association of Regional Media Centers. I am also the director of the Burlington County Audio-Visual Aids Center in New Jersey which serves 62,000 students and 138 schools. I want to thank you, first of all, for allowing us the opportunity to comment on this issue. Our initial awareness of the issues which have led to this review came from an industry association which had taken the position that they would seek to prohibit tax exempt and government agencies from competing with for-profit businesses. This association, as part of a larger group, is actively involved in lobbying in Congress and the States to get the prohibitions they seek.

The National Association of Regional Media Centers consists of over 260 agencies, serving over 20 million students in the United States. Almost all of our regional media centers were established by state law and code to provide centralized media, film, video, and computer resources to multiple school districts. Many of our members also provide printing services, audiovisual, and computer equipment repair services, and licensed video duplication for their school districts. Some of these services are provided at an additional cost. In some states, this is a mandated service and provisions have been made to allow for billing for the service.

To the best of our knowledge, none of our members offer or provide these services outside of the multiple school districts which they were mandated to serve. Our concern is that, since the National Association of Regional Media Centers does not have a paid staff, and we do not have the resources to print slick informational material to give the lawmakers, that our voice be heard. Our member agencies provide a vital and needed support service for the Nation's schools. We ask that, in the effort to revise this portion of the code, and no doubt it needs revision, that provisions be made to allow State and local education agencies to continue providing cost-efficient services to their constituencies.

In the good faith effort to respond to the criticism of the code, we ask that, please, we not have our hands tied in providing regional services and that we not have our hands tied because of a forgotten notwithstanding clause or a lost comma. Thank you.

[The statement of Mark L. Richie follows:]

TESTIMONY OF
THE NATIONAL ASSOCIATION OF REGIONAL MEDIA CENTERS
BEFORE THE SUB-COMMITTEE ON OVERSIGHT OF
THE HOUSE WAYS AND MEANS COMMITTEE.

The National Association of Regional Media Centers represents over 265 educational technology service agencies in 39 states serving nearly 20 million students. Our membership also includes over 60 educational film production and distribution companies.

The primary service provided by our members is the review, acquisition and circulation of educational media resources for the schools located within a given geographic region. These resources include films, videotapes and computer software. In addition to this, many of our members provide audio-visual, video and computer repair, printing, graphic design, video duplication, television production and joint purchasing services.

Most of our member agencies were created through local legislation or by state code and are supported through a variety of funding methods which vary from state to state.

Our intention in this testimony is to make the committee aware of the circumstances surrounding the operations of our member media centers and to provide background information for the committee to consider when reviewing policy connected with the unrelated business income tax. Our concern is that any contemplated change in the tax code might unintentionally restrict, reduce access or drive up the cost of services needed by the nation's schools.

***

Our basic service of providing educational video/film resources began in the 1950's. Regional film centers were established to pool scarce resources and purchase educational film materials which were too expensive for individual schools to purchase in adequate quantities. This pooling of resources and interdistrict cooperation allowed for greater utilization of material, significant cost savings, equity of access across many districts and established a central collection far larger than any individual district could assemble, with the exception of large city schools. Many states also mandate that other services, including printing and equipment repair, be provided on a fee basis.

Today a typical regional media center provides area schools with 379 hours of educational programming per week at a cost of less than $32 an hour. Compared to a typical instructional television station which puts out 35 hours of educational programming per week at an average cost per hour of $450.

A natural outgrowth of a film circulation system was the need to keep film projection equipment in operating condition and good repair. In some areas of the country there was no local, convenient shop where repair work could be done on audio-visual equipment. The regional film centers took on the task and established repair services which, in some cases, now encompass computers and video equipment, as well as audio-visual equipment.

In other areas of the country, regional media centers started repair services at the request of member schools who were dissatisfied with the quality of repair work done by private businesses. In these areas, school districts found that slow turn around time kept vital equipment out of the school for prolonged periods of time. They also experienced a consistant problem with poor quality of repair, charges for parts which were not replaced and service which was not performed. When this track record was combined with increasing costs and no corresponding improvement in quality of service, school districts naturally turned to alternative solutions.

All of the above problems are further compounded by the tradition of slow payment by school business offices. It is not uncommon for bills from repair companies to go unpaid for 90 to 180 days. When a private business is confronted with this kind of billing problem they become reluctant to continue to deal with the schools. Frequently the excuse for slow repair time is the problem of slow payment.

Schools depend on their limited numbers of audio-visual equipment for daily and routine instruction. One 16mm projector, out of service for six weeks, may represent 25% of the equipment assets in a school and thus severely restrict media utilization.

The result is the existance of central equipment repair services located in regional media centers. They generally provide door to door delivery, bill quaterly, and turn equipment around under 36 hours at a cost ten to forty percent lower than commercial firms; if they can find one. Even in the most populated areas of the country it is difficult to find a single company which will handle all the audio-visual, video and computer repair needs of the school community. Schools might use six or seven different repair outlets because one can't handle computers, another won't do a certain brand of projector and another can't work on video decks. This inability to work with a single repair company eliminates any possibility of volume discounts, complicates making arrangements for repair work and does nothing to foster a good working relationship which could yield better service. In rural parts of the country the problem is much worse. Schools in Lake View, Iowa have no less a need for quality AV equipment repair service than schools in Chicago.

The bottom line on repair is that, for the most part, regional media centers wouldn't have gotten into it if service from the private sector had been adequate to begin with.

Our concern now is that, if by default, we are no longer able to offer repair work, it will result in the schools getting substandard service at increased cost. A combination which is of no benefit to the taxpayer.

There are larger implications connected to the high cost of equipment repair which effects the private sector, notably the commercial producers of educational video/film materials. School repair budgets are vastly underfunded. A problem which is further complicated by the influx of more than one million computers to the nation's schools in the last five years with no corresponding increase in equipment repair budgets. The imperative to find the most cost effective way to keep equipment running becomes more pressing.

If schools are forced back to high cost, private sector repair shops, and there is no increase in repair money, then a lot of equipment will go unrepaired. Teachers will have access to fewer and fewer projectors which will result in lower use of video/film resources. Lower use, lower demand, could lead to fewer purchases of educational video/film product, which ultimately would adversely effect an already shaky educational film industry. Ironically, teacher surveys have repeatedly shown that 75% to 85% of them feel that video/film materials are either valuable or essential to the instructional process. But this means nothing without adequate numbers of working projectors and video decks in the schools.

Educational film producers are interested in the continuation of regional media video duplication services also. Many of them routinely sell duplication contracts to regional centers which allow licensed reproduction of educational films. Part of the reason they offer this is to keep from having to do the duplication themselves or invest in the equipment and human resources needed to do it on a mass scale.

The educational film market is only about $60 million a year. Or about the same cost as two Navy F-14 fighters without spare parts. We who buy educational films would like to know that we will continue to have a choice of quality, well made, educational films from which to choose. If too many film companies are forced out of business by reduced sales then we loose both the quantity of titles and the richness of diversity which competition encourages.

***

Many regional centers also offer printing services for their constituent school districts. The evolution of this service roughly runs along the same lines as equpment repair. Schools are generally inadequately funded to meet their own printing needs at commercial prices. Schools need report cards, record cards, envelopes, stationary, teacher, parent, and student handbooks, curriculum guides, newsletters, fliers, programs and dozens of other items printed each year. Regional media center print shops know the needs of schools and offer the advantages of quantity materials purchasing, quick turnaround, door to door delivery and workable billing terms.

The teachers, students and parents deserve to get and use quality publications. Again, if by default, regional centers are no longer able to offer such services, than the alternative will be that schools, once again, will be expected to do the same with less and the result will be lower quality and higher cost.

***

The services offered by regional media centers are generally available only to constituent school districts. As far as we can tell, none of our members solicit or provide service to organizations outside the scope of the schools which they were originally chartered to serve. In many areas there exists a close working relationship between local small businesses and the regional media center. A climate of mutual respect exists and in general actually generates additional billings for the small business.

The National Association of Regional Media Centers is concerned that revisions in the existing tax codes leave enough latitude for the continued operation of support services to the nation's schools. We urge the Committee not to recommend changes which would tighten the code so much that needed services are curtailed or elminated - leaving schools with a choice between inadequate, high cost service or no service.

During the last fifteen years education has seen a massive retrenchment of Federal aid, placing the burden on state and local tax bases. Continued reduction of Federal support forces schools to do the same with less. Regional centers attempt to mitigate the problem by providing consolidation of resources, group purchasing and quantity discounts in order to make tax dollars go as far as possible.

In an era of sweeping tax reforms, we don't want our services swept out of existance because of a forgotten comma or neglected phrase in a revised tax code. The result would compound an already existing funding crisis in educational technology and would leave thousands of districts without cost effective media support.

Additional information may be obtained from:

Mark L. Richie, President
National Association of Regional Media Centers
c/o Burlington County AVA Center
122 High Street
Mount Holly, New Jersey 08060

609-265-5053

June 1987

Mr. **Flippo**. Thank you, Mr. Richie. Dr. Saloom, your testimony appears to support the American Council on Education's assertion that applied research and the continuing involvement of universities is necessary to effect in the technology transfer. Yet we have many major corporations and small firms, as well, in the private sector that are engaged in similar types of applied research. I wonder if you could help us understand any differences between the applied research that you and your university or other universities may be doing, and what the private sector is doing in applied research?

Mr. **Saloom**. Thank you. I would like to do that in two ways. First, since the Council on Research and Technology is a corporate and university group, it is a complicated question and I will give you my best answer, but we would be very happy to work with this subcommittee and to draw the line that is fair to both university and business. My point of view is that there is very little corporate basic research performed. Except for a few large companies in America, over half of that is done in universities. When it comes to applied research, I think that is a very difficult term. The distinction is clear between basic or applied research and product development. That is a clear distinction. I think we will have very little difficulty with that.

I will give you the example of superconductivity. We have known for years and years about superconductivity. We know today we have superconductivity at some higher temperatures from the University of Houston. Today, in applied research in super-conductivity, we are saying how do we increase its current density to be more practical? How do we make the material in films, sheets, wires or whatever it may be. There is no commercial intent in mind. At that point, Paul Chu is not thinking of levitating trains and making high level transmission lines. That is a product. We believe it is extremely important that the applied research in universities remain in the tax exempt status.

So we would be very happy to work with you on that but I do not really see—I think it would be a terrible mistake if applied research, which is key in that whole continuum, is not remaining as it is today, in a tax exempt status. But I would be happy to work with you on that.

Mr. **Flippo**. Thank you for that. I think Dr. Wu at the University of Alabama at Huntsville would also agree with your statement, as well as Dr. Chu at the University of Houston. Well, that is the essence of our difficulty in trying to figure out where to start and how to separate those two activities. Thank you for your comments. Mr. Richie and Mr. Allen, would each of you care to comment upon any criticism that you have heard of your operations. Could you tell us what are the concerns of those that are criticizing not-for-profit firms that offer similar educational services, or printing, or audiovisual?

Mr. **Allen**. I think that the statement that Mr. Elliott presented to the committee from the producers/distributors, is indicative of the fact that there has not been a lot of criticism of the role of the university film rental library. And so that we have asked for the opportunity to address the committee, so that we would bring to your attention the fact that there are these kinds of functions which are jointly agreed upon by both the university and the film distribution or the for-profit sector, as being essential parts of the distribution mechanism, and that these not be accidentally done any harm in the corrections that you are making to the situation as it exists.

Mr. FLIPPO. Well, in the interest of brevity, Mr. Richie, you might like to supply the answer to that in writing. Let me ask each of you, do you consider that all of the services that you provide, are related to your tax exempt purpose, and if not, what are your sources of unrelated business income?

Mr. ALLEN. As far as the university film rental libraries are concerned, I would stand with the earlier statement that they all are related to the purpose of the university and that all of the income is related purpose income and that there are not any, as far as just the rental library function is concerned.

Mr. FLIPPO. Mr. Richie?

Mr. RICHIE. The regional media centers in the United States, which do provide audiovisual equipment, computer equipment, repair services, and printing services, are mandated to provide, in most cases, that service to their constituent school districts or they have code which is phrased in such a way as to allow them to do that if it is deemed to be in the common good and benefit of the school districts in their region. That is what tends to come in the criticism through NARMC is local print shops and/or local individual equipment repair agencies criticizing that as being unfair advantage.

Mr. FLIPPO. Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman. Thank you, gentlemen, for your testimony. I want to get into another area. Can you generally tell me how your salaries compare to others in the private sector in a competitive area?

Mr. ALLEN. Probably not. I don't think that information has been compiled.

Mr. SCHULZE. It seems to me that if we have universities and they are paying people much less than comparable salaries, that would have an impact or an affect. If they are paying much more because they are both "teaching" and running the unrelated business at the same time, that would be another aspect. And so, I am curious as to whether that is a factor or whether you consider or whether that is not a factor.

Mr. ALLEN. I personally served for about seven and a half years in management roles in private industry before coming to Penn State about 11 years ago. The transition from private industry to Penn State caused me to take a reduction in salary. However——

Mr. FLIPPO. You want to tell us how much that was, Mr. Allen, or percentage-wise?

Mr. ALLEN. It was probably in the neighborhood of 20 to 25 percent, as best I remember. It was not the most happy memory in my economic life.

Mr. FLIPPO. Has that since equalized?

Mr. ALLEN. I am now at a higher salary than I was 10 years ago. Whether it is comparable to private industry, I am not in a position to know.

Mr. **Flippo**. Well, we all know that there are certain fringe benefits involved with academic life.

Mr. **Allen**. That is correct.

Mr. **Flippo**. And that are not available through the private sector and they add up.

Mr. **Allen**. That was one of the reasons why I made the decision. It is a life style in addition to the fringe benefits that make it very attractive and I think that would be generally true of employees at the university, that they are probably not paid as well as they would be in industry, but there are some other benefits that accrue in terms of longevity.

Mr. **Flippo**. Let me be very candid, Mr. Allen. I have heard stories of college professors being paid $70,000 or $80,000 or $90,000 a year. They teach one course and they usually have an assistant to help with that, chore while they are off spending their time with research or writing papers or doing other things which generate income. Do you know of examples like that or is this all rumor that is being put forth?

Mr. **Allen**. Well, as a staff member at a university, I have heard those stories, too, and I wonder if they are true. I do not have any hard evidence one way or the other anymore than you do because it is a different group of people within the university structure.

Mr. **Flippo**. I have parents that come up to me when I am in the district and are all upset about tuition increases they allege that one of the reasons for the rising costs are those professors who do not really teach and have assistants do it while they are making these enormous salaries. So if they are not, it would probably be well to get that information out. If you do have any information on this, we would be happy to include it is the record of these hearings. Tell me about charges for comparable work. Do any of you have any information on comparable charges for comparable work with the private sector?

Mr. **Allen**. There are film companies that rent films to colleges and universities in the same way that university libraries do and each of them is free to set their own fees. In some cases, they are considerably higher; in some cases, they are comparable; I do not know of any where they are lower but they could very well be that there are lower.

Mr. **Flippo**. All right. So, the message I am getting, Mr. Allen, is that you price yours below the going rate? State it more for specifically, if that is not correct.

Mr. **Allen**. Our pricing schedule is developed on the basis of our actual costs. Once each 3 years, the university controller's office conducts a cost analysis and we then set our prices according to what our costs are. That cost does not include the paying of taxes. It does not include profit so that the chances are that we would be operating at a somewhat less cost.

Mr. **Flippo**. So you are saying that just exactly at cost, not one percent above or——

Mr. **Allen**. That is as best as you can do when you do it every three years, yes. As Mr. Elliott indicated in his statement to the committee from the commercial sector, this is not a business that they were interested in getting into as commercial companies because they did not feel that it would be a profitable business to be running.

Mr. **Flippo**. Mr. Richie?

Mr. **Richie**. I will respond to that also on the print and equipment repair. The costs that we tend to come through, the billings that I tend to see, are anywhere from five to perhaps 25 percent lower than what the billings would be from a commercial establishment and that covers both printing operations and also equipment repair services. The primary reason for that tends to be that those operations within a regional center are run as a cost center on a strictly cost-for-service, break-even level that there is no cost, at least to my knowledge, that there is no revenue generation there in order to subsidize some of the service within the agency.

Mr. **Flippo**. Dr. Saloom, do you care to add anything to that about the research?

Mr. **Schulze**. It seems to me that when you are talking about freedom from state and local corporate income taxes and property taxes and non-profit-mailing privileges and sometimes, duty-free importations, and all kinds of other advantages, that there are opportunities to sell or rent at very low, advantageous prices. And even at 25 percent below, it seems to me that there are opportunities for making money and still undercutting the rest of the market in some of these areas. I thank you very much. Yes, Mr. Richie?

Mr. **Richie**. If I could comment just briefly on that. Part of our problem nationally is the unevenness of the availability of some of these kinds of services across the country. There is a very fine network of regional centers in Iowa, for example, which provide, in some cases, the only computer equipment repair services for 150 or 200 miles in any direction and that is common in many, many states. Our problem with trying to work with the committee with this, is the uniformity of it. That the code covers everybody across all States and you may end up in a situation where accidentally, somebody out in the Midwest, their school districts are suddenly cut off from quality, quick, turnaround repair services.

Mr. **Flippo**. Thank you. Thank you, Mr. Chairman. Mr. Thomas?

Mr. **Thomas**. Thank you, Mr. Chairman, thank the panel. Dr. Saloom, is there any merit to the argument that one of the problems we are in today is that, even in the area of applied research, and obviously in pure research, that the kind of cutting edge of high technology equipment necessary, limits the pool of universities to probably a greater degree than ever before, either in having it or in providing the equipment for research purposes. It is a little bit like every community hospital wants a Cat Scan, but it just cannot be done on an economic basis. Is there much merit to that argument and that is one of the reasons we have narrowed the base of those universities performing some of the most advanced applied and pure research?

Mr. **Saloom**. Indeed. It moves even a step further. There was a time, as you mentioned earlier, that we could do test tubes, and beaker and bunsen burner type research and I think the cutting edge technology has moved much beyond that, and even much beyond just the individual equipment. For example, if one wants to do submicron lithography, for example, in advanced compound semiconductors, then one needs the facility to be vibration-free, to have less than 10 or 100 particles per cubic foot. Then within that goes the equipment and then goes the research at the cutting edge.

I think this is an extremely important national issue and I think anything we do, here, on this issue of unrelated business income tax, which is an extremely important issue, ought to send a message back to the research community, that there are not any disincentives, that we are really encouraging this. This community is entering in this next decade with the need for the most advanced facilities, equipment, and research that we could muster. Space used to cost us $50 a square foot. To do what I just described is $500 a square foot. Are we short? Indeed. It is very serious.

Mr. THOMAS. One of my concerns is that, with the exception of maybe a few corporations, I believe there are some engaged in, at least, a modified form of pure research with general areas just for R&D purposes, 3M and others maybe. But what we need to do is encourage a greater degree of inter-relationship and support between specific industry sectors and the universities. This has occurred somewhat naturally in the Silicon Valley area, in the Massachusetts area, and they are attempting to develop it in Texas. I want to try and assure you folks that in no way are we relating the selling of toothpaste or bowling alleys with the kind of concerns that you have. We will do everything we can to make sure that those vital concerns are supported.

Mr. Allen, I think it was useful for you folks to testify but I think Mr. Elliott's statements, sometimes, it is better to have others speak for you than to speak for yourself. It is nice to see that they recognize the role that you perform. Can you give me some idea of one, the depth and breadth of your library and two, the kind of folks that draw on its resources? An example. Obviously, you will have educational films, archeology films, films that are for specific class applications that would be checked out by classes or schools for a period of time.

Do you also have what we would probably call American film classics or what would have been commercial films because, obviously, in art appreciation courses or film courses, you would have those available and do you check them out beyond the greater university? For example, would you check them out to the student body officers, and they would then charge a quarter for movies? Do you do that? Or would you also reach out to some of the community organizations as well? What is the depth of your library and the scope of those who draw on it?

Mr. ALLEN. There are two types of libraries that are counted in our membership. One type, which is primarily interested in serving the needs of the public schools in those areas of the country where you do not have a regional media center, such as Mark Richie operates, and so they are buying films which are produced for curriculum applications in the schools as their primary focus. The second type of university rental library is the type which Penn State has, which is one which has been developed to serve the educational needs of higher education. Specifically, the needs of the Pennsylvania State University in our 22 locations. The rental business then comes from other colleges and universities which make use of the materials which we have when they are not being used by our own faculty in teaching.

The feature film business, which I think you are referring to is the entertainment types of things, is handled in another complete arena of film rental, which is handled entirely by the profit sector. So that if we are teaching film appreciation and we want to use King Kong as an example of a classic film, the film department then goes to a commercial company, rents it from them. We do not have access to them. There are no more than a handful of feature films which have ever been made available for rerental to university film libraries. It is not part of our business.

Mr. THOMAS. In passing, Mr. Chairman, I would commend the three-paragraph statement of Mr. Elliott, especially where he mentions the National Geographic Society and others, in terms of exactly how and why they are where they are. Mr. Richie, I am listening to your oral testimony and then, in reading your written testimony, apparently there was some difference between the two and could you rephrase for me, or repeat the statement about the inability to produce slick materials for Congress? Perhaps I misunderstood your statement. What was it that you said?

Mr. RICHIE. I believe what I was referring to was that the National association of Regional Media Centers is a voluntary association of these 260 regional media centers and the association, as distinct from its member agencies, is not in a position to produce informational materials, slick informational, four-color, duplex stock material, and get it to the people who are in a position to make change, revise, or recommend revisions to laws.

Mr. THOMAS. I believe you referred to Congress.

Mr. RICHIE. Yes, sir.

Mr. THOMAS. Why would Congress want four-color, slick material? It is not how it is presented, it is what is presented that it was our concern, for example, with the last panel.

Mr. RICHIE. Yes, sir. I understand that. What comes across people's desks sometimes is what is bigger or better looking sometimes is seen quicker and faster. That was my only comment on that.

Mr. THOMAS. I understand your difficulty. One of the things we are trying to do now on another committee that I serve, the House Administration Office Systems, is we are taking over our various district offices. We have had a uniform standard and as your concerns in the Midwest and in other areas, some of our district offices simply cannot get the kind of computer services necessary and that we have been in the throes of deciding whether we set up a centralized operation and fly people out with the equipment to repair it or figure out a way to get an outreach program in various regions. People are going to use this technology. It does need to be serviced and I think the job that you are doing is a difficult one and it certainly is one which I think falls within the purview of what is appropriate and acceptable under the law. I just do not know why you felt necessary to prejudice your testimony with those kinds of comments. But thank you very much for your input.

Mr. FLIPPO. Thank you. Gentlemen, we do appreciate your testimony today. Thank you for being with us. We will, of course, include your entire statement in the record. The third panel that we have for today consists of a group of individuals involved in for-profit research discussions. We have Mr. Brong, of the Association of Washington Businesses. We have Mr. James W. Johnson, who is the president of Amador Corp. We have Mr. Grover Williams, who is the president of the American Council of Independent Laboratories and we have Mr. Donald Carlton, a member of the board of directors of the Professional Services Council. And I might say that our chairman, Mr. Pickle, really wanted to be here for this panel, but he has had to be away in another markup on a very important bill. He will return as soon as possible. Why don't we start, Mr. Brong, with your testimony. We will take the testimony of all the witnesses before going to questioning. Please proceed.

STATEMENT OF GERALD R. BRONG, ED.D., EDUCATIONAL SERVICES DIVISION, COMMUNITY COMPUTER CENTERS, REPRESENTING ASSOCIATION OF WASHINGTON BUSINESS, AND INTERNATIONAL COMMUNICATIONS INDUSTRIES ASSOCIATION

Mr. Brong. Thank you, Mr. Chairman.

With my wife, Marlene, I run a small business in Pullman, Wash. We entered business in September 1982. We entered bankruptcy under chapter 11 in April 1986. Progress has been made on our reorganization, but it's interesting to note that in the Chapter 11 reorganization process, it has been officially and formally identified that one of the primary reasons for our business difficulty was competition with a not-for-profit reseller of micro computers, software, and other paraphernalia that goes with the industry.

My name is Gerald R. Brong. I have served on the faculty of Washington State University for 20 years. And I'm happy to report that Congressman Thomas has given approximately half of my testimony in his questioning. I appreciate that and it will allow me to address some other points in the short time I have.

Pullman is a university town with 22,000 population, and within that town, approximately 80 to 85 percent may do business with the university's supposedly closed retail stores. Now, we are going to be looking at negatives this morning in my testimony. I don't have time to list all of the positive advantages we have with a major university in our city.

The speakers on the first panel implied that, in many cases, their universities have a right to do business. I wish to challenge that. If that indeed is the case, do they have a right to compete unfairly and, if so, do they have a right to put my business and other businesses out of business? I would argue that is not the case.

In the city of Pullman, the university controls 50 to 55 percent of all retail sales of everything except automobiles and groceries. We have identified that from the Washington State Department of Revenue figures. We are not accountants. We have done the best we can to identify those numbers, and I would be glad to provide the Department of Revenue figures as you wish. Your numbers, I am sure, will at least exceed 40 percent.

Let's look at the Pullman businesses, if I may, that are listed in my testimony that was presented to you on June 8, and I would like to list the businesses in Pullman that my memory tells me over the last 12 months have either changed status, closed, or are in serious trouble. A full line clothing store, closed; young women's clothing store, closed; phonograph record dealership, seeking a buyer; general gift item store, closed; computer dealership, one closed, and I'll tell you we're hurting; exercise health studio forced to diversify into media graphics production because of competition with university health and gymnasium facilities, such as weight rooms, et cetera. Local newspaper experiencing reduced advertising and single copy sales. It is interesting to note the university subsidized newspaper does nearly $700,000 a year in advertising.

The list goes on as you will see in the testimony.

Pullman is not alone in the problem that is being experienced. Based on testimony that was given Monday and the directions from the chairman, Mr. Pickle, I did some additional research and pulled some materials out. I would like to make reference to a publication that's from Portland, OR., that's entitled "Mouse Tracks." It deals with computers, and it's the Portland Mouse Users Group as they call themselves. It's a series of advertisement. It is the buyer's guide for 1987. The top listing on that page is the NYNEX Business Center, which is a for-profit national chain. The second listing on the page is Pacific University Computer Store, a not-for-profit store, it so states on their listing. The third listing on the page is PACTEL Information systems.

As we look at the research that was recently done by NOPA, an organization to which I do not belong, and I claim no influence on their survey, they asked members to describe their not-for-profit competitors. And I find it interesting that as we look at some of these areas—and I only mentioned a couple of areas of response—in California, they list University of California, Santa Barbara, sells Apple, Zenith computer to students and faculty. Illinois, University of Illinois; Michigan, University of Michigan; Missouri, university subsidized computer stores; Washington University in Missouri; Carlton College in Minnesota; Memphis State University, Tenn., and the list goes on.

They asked how long have these businesses faced competition? Thirty-six percent said for 5 to 9 years. They give other timeframes as well. There is all sorts of interesting information that could be obtained by the committee from NOPA.

This serves to point out that Pullman is not the only city facing problems. The educational technology industry in general, the firms that sell computers and audiovisual equipment, tape recorders, sound recorders, has an association known as the International Communications Industry Association. There's about 800 members. The estimate we have is about 20 percent are experiencing some form of competition. I have an example of one form of competition that I'll be reading from the cover of a not-for-profit resellers catalog. It says "Our purpose, to help you reach others with a saving message of Christ. The services of this ministry are available to Christians and Christian workers worldwide." It's mailed on a not-for-profit organization postage permit.

As we look at a couple of prices in here, just to see how their not-for-profit activities really do sort out—and I have a number of prices I can enter into the record if you wish—there's one device that is a multiple tape duplicator that's frequently used by these kinds of activities.

In the Audiovisual Equipment Directory, that's published by ICIA, with information provided by manufacturers, they claim that the list price of a given model we're making reference to, which is the Recordex Model 315 Duplicator, the directory, which is the manufacturer's literature, says it is $1,795 suggested list price. This organization that gives significant discounts says the special price is $1,795, the retail is $2,695. There's about another 10 pages I've marked in here with examples.

When we talk about the repair and maintenance of computers—this is another area in which we're finding difficulty throughout the country, it's already been addressed in questioning, I will not go back into that further.

I would also like to point out other businesses in the State of Washington, if I may, that are experiencing difficulties in competition, so that it's clear that we're not just concerned, at least in the Association of Washington Small Business Council, with computer sales.

We have State run laundries bidding on the open market for commercial services, such as hospitals, hotels, et cetera. A marina is being run by port districts that establish boat facilities and, in some cases, they rent out in the same port the second marina for a for-profit operator, and they will operate under two sets of regulations and rules.

County fair boards that operate horse boarding stables, engineering laboratories which we'll hear about later; charities opening and operating restaurants and food services, and I don't mean at the weekend bazaar.

Educational software. We heard questions about slick materials. I call your attention to this catalogue, which is far better than anything I would be able to produce, called Conduit. Conduit is a nonprofit organization that publishes educational computer software, organized in 1971, with funds from the National Science Foundation. Tax dollars developing competition in our field.

Another catalog from the Minnesota Educational Computer Consortium. I even sell their software. It's excellent. It's a State operation of schools, but it's become very big, very aggressive, and it has excellent materials that could be distributed at comparable prices, since their prices are not that cheap, by the commercial sector.

In looking at the material that has been prepared for the committee, the GAO study has excellent information, and you've had Small Business Administration reports, and I'm sure the committee knows well the information from the White House Conference on Small Business to which I was a delegate from the State of Washington. Which brings me to a point that I think is important to note. My firm is in chapter 11. I have no spare resources. My participation here today is paid for by small donations from businesses in the city of Pullman, $5 to $25 average, some of which requested to remain anonymous in this city.

I have a number of well wishers. In fact, I have one lady that met me on the street—she knows I'm a city council member in Pullman—and she offered me a five dollar bill, and said I hope this helps.

Well, when we look at the Department of Treasury report, and I have gone through the materials, in general I think we could agree with the offers of ways things should be changed and the suggestions they have made. If you wish, in the questioning period, I can address specific points on those parts.

We have a very difficult problem. It's one that is extremely significant. When we see these kinds of articles that appear in newspapers—this just happens to be again about one local newspaper—the university in my city, to look at ways it picks private pockets. More than 600 money making ploys, and the article goes on to elaborate. Well, I wish to correct that. It's not really 600; it's closer to 200.

This is a matter about which I have high concern. I think it's evident by my testimony. I do appreciate a chance to address the committee today.

Thank you.

[The statement of Mr. Brong follows:]

Testimony Of

Gerald R. Brong, Ed.D.
Co-Owner with Wife, Marlene Brong
Community Computer Centers
East 330 Main Street
Pullman, Washington 99163

Presented To
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Tentative Presentation Date - - June 25, 1987

===

June 8, 1987

Mr. Chairman, members of the committee, and guests, I am Gerald R. Brong from Pullman, Washington. With my wife as majority owner, we have operated Community Computer Centers, in Pullman, since September of 1982. Marlene and I moved to Pullman in 1965. At the present time I serve in the At Large position on the Pullman City Council as an elected member.

In June, 1986, we were forced to enter bankruptcy under Chapter 11. This action was to provide protection from creditors while Community Computer Centers restructured its business and found markets away from Pullman. The local markets for the sale of micro computers, printers, data storage devices, and applications software had become dominated, starting in 1984, by a new retailer. The retailer in question is tax exempt, receives indirect (and possibly direct) subsidies from tax payers through government funding processes. Further, this retailer is given preferential wholesale prices by manufacturers and publishers because of its status as a tax exempt educational institution. This reseller of an estimated $2,000,000 in computer products is a tax assisted state university.

In my comments I will reference one university. Unfortunately, I only know this one university as a business competitor. I cannot speak from experience about the many other universities that are engaging in competitive business practices. I could take hours describing what the university in question does well. It is a great institution. But I will take a few minutes describing a problem the university has created locally. This problem can be traced back to the tax exemptions given to the university, and its commercial programs, through the federal tax code.

Before I address the issue of unfair competition, allow me to give some necessary background information.

I appear here today with my costs covered in part by donations from small business persons in Pullman that share my concern about establishing fair business competition in our community. I also asked for support from fellow delegates from northwestern states to the 1986 White House Conference on Small Business. It was these business persons that identified unfair business competition from tax exempt organizations, and government agencies, as the third most important issue facing small business in our country.

I am speaking for these small business owners.

I also address the Committee on behalf of the Washington Small Business Council which is a Council of the Association of Washington Business. And my views and report are representative of the position held by my trade association, the International Communications Industries Association.

The tax exempt organization being questioned is the single largest employer in Pullman and provides a significant portion of the financial fuel keeping our strained local economic engine operating. It is a very important part of our community. As a comprehensive university it contributes greatly to the quality of life we have in our region. Business persons in our community support the university, depend on the university, but we can also be hurt by university practices.

Let me describe Pullman. Located in the rolling hills of the Inland Northwest the city is located on the Idaho/Washington border 90 highway miles south of Spokane. Approximately 22,000 persons make up the population of the city.

Of the 22,000 residents an estimated 15,000 are enrolled in the university, an estimated 1,000 work for the university, and an estimated 1,500 are either the spouse of a student or employee or hold some other very close relationship with a university affiliated person. An estimated 80% of the community are directly affiliated with the university which operates tax exempt businesses.

The May 2, 1985, Idahonian/Daily News (pages 1 & 12) carried a front page headline, "WSU to look at ways it picks private pockets." The subhead read, "More than 600 money-making ploys." In all fairness to the university it is more realistic to state that the university has about 125 to 150 "commercial-like" activities.

In 1985, based on estimates we local business persons could develop, we estimated that approximately 50% to 55% of general retail trade in our city was controlled by a tax exempt organization. That trade in question amounted to an estimated $12,000,000 to $14,000,000. Our figures are based on Washington State Department of Revenue quarterly reports.

Included in those figures are the two programs I will address in the next few minutes. They are the Washington State University Student's Book Corporation and the Personal Computer Center.

On Friday, June 1, 1984, the university's Board of Regents approved the establishment of the resale program for computers and related products. In justifying the request from the university's administration to the Regents, Associate Provost Lane Rawlins is quoted in the June 2, 1984, Spokesman Review (page 6) as saying, "The bottom line here is that WSU is a competitive institution. We must make these goods available if we are to remain competitive."

Rawlins, so the article points out, reported that other western universities are already selling computer products. He is quoted as saying, "Unless we go ahead with this program, we are going to lose faculty and students to other universities." Justification for establishing a computer store — faculty and student recruitment. Of course, there are other reasons.

The plan was that only university related persons (students, staff, and faculty) would be allowed to buy at the university's computer store. This store was closed to the general community. But, please remember that in Pullman 80% of the local market is qualified to buy at that store. If we estimate the slippage of merchandise beyond the restricted buyers' group there might be an increase to 85% to even 90% of the community that might be able to acquire products from the store.

I can assure you that private, for-profit, tax-paying membership based buying organizations (some call them warehouse stores, buying clubs, or discount warehouses) would be overjoyed if they could develop an 80% membership base in a community, enjoy special postage privileges, have direct access to the line of credit of a state university, receive discounted advertising rates in a local newspaper, have all utilities provided from a central utility service, have access to a government telecommunications system, plus have the good reputation of a university.

The Personal Computer Center is operated by university staff in a university classroom and administrative building. The PCC has a Washington State Department of Revenue resellers number just like Community Computer Centers. Both of our stores collect sales tax from our customers. But that is where the similarity ends.

The university store may be in a building that was built, at least partially, with federal funds. Not the building in which C^3 rents space. Employees at the university store may be on government funded work-study programs. None of my employees come to C^3 with any subsidies. If the university's line of credit is used to buy merchandise for inventory there may be no credit costs. When C^3 buys inventory we pay about 13% annually plus bank service fees. If C^3 uses the telephone system to place a long distance call I pay a commercial rate. When the university store makes a long distance call it uses the Washington State Controlled Access Network. Oh, yes, the list could go on.

In the first couple of years the Personal Computer Center was an aggressive competitor. Special sales, regular advertising in the university run newspaper, distribution of notices to employees through the university's mail system, premiums to buyers, rebates, and other trade stimulants were common. The PCC was a retailer just like anyone else — except it had certain advantages we can only dream about.

In 1984 through 1985 cooperation between the university's store and other area resellers was non-existent. There was a perception among small business that the university could do what it wanted in the way it wanted to do it.

I wish to now look at another multi-million dollar university-based reseller of general merchandise. Also at the university in Pullman.

The Washington State University Student's Book Corporation was established over 20 years ago. It was established at a time before there were adequate private retailers supporting the specialized needs of students and faculty at the state college with its engineering and agriculture schools operating with other areas of specialized study. When established it was necessary. But in 1987 many changes have occurred in the community.

The WSU-SBC is a for-profit tax-exempt reseller (Pullman Herald July 9, 1986, page 1) that, based on its articles of incorporation as amended in March, 1973, can sell general books, text books, stationary, insurance, real estate, refreshments, general mercantile goods, and services to the students of Washington State University. (Pullman Herald, July 9, 1986, pages 1-2.) The stock from the WSU-SBC is held by the Board of Regents in trust for the students.

The corporation is run by professional managers. A board of directors including students and university staff advise in operations and make policy decisions.

Purchases at the WSU-SBC can be made by anyone with money. The WSU-SBC, though different from the university's computer store, is very much a concern for local merchants. The WSU-SBC dominates the market in designer blue jeans, stereos, small refrigerators, gift items, selected cosmetic lines, stationary and art supplies, selected computer and software product lines, and, of course, books. Some of my Pullman business colleagues would claim that the WSU-SBC competes in the majority of retail market we have in the city or even the county.

There was even a situation recently in which the WSU-SBC operated an illegal lottery that had to be stopped by the appropriate state office.

In addition to the computer store and department store university programs sell dairy products, long distance telephone services, health and recreation facility access, food service catering, engineering consulting services, media production services, and the list could go on. The university offers services that were established with good intentions but over time they may have become a problem for all involved.

In a community, like Pullman, that has a dominant organization, like a university, there are unique problems impacting on businesses. From memory of the past 12 months, let me list Pullman businesses that have closed or are in trouble where there might be a relationship to the WSU commercial activities:

A full-line clothing store (closed)
Young Woman's Clothing Store (closed)
Phonograph record dealership (seeking a buyer)
General gift item store (closed)
Computer dealership (1 closed & 1 hurting)
Exercise Health Studio (forced to diversify to survive with campus activity)
Local newspaper (experiencing reduced advertising & single copy sales)
Local radio station (loss in advertising to 3 university stations — and now this WSU radio program expands through the Inland Northwest and is reaching into southern Idaho)
Shoe Store (hurting — lost sales of athletic shoes)
Radio-TV Store (sold following losses of sales in portable TV & stereo lines in competition with on campus retailer)
Stereo specialty store (1 closed and 1 hanging on)
Photo-film processing firm (local owner gave up the struggle)
Appliance dealer (loses sales of small appliances now sold and rented by university programs)
Electronics firm (lost opportunities to sell service as university establishes more in-house services)

There may be others. Not all of these business were run by incompetents. Not all of these businesses with problems (or those that failed) had owners lacking business skills as has been implied by people opposed to our questioning of the university's business activities. It is even untrue that all of these businesses could stand aggressive business competition. It is the issue of fairness and unfair advantage that is being questioned. The local businesses need the university, its students, staff, and faculty. Likewise the community needs the businesses. Needs of the university can be served by the businesses.

It is totally unfair to imply that all business problems are caused by the tax exempt organizations operating in our Pullman market place. But there definitely seems to be a relationship. It would also be unfair to imply that there is nothing positive in the relationships between the university and community. We in Pullman are very fortunate we have Washington State University. It has a very definite positive impact on our quality of life. But the tax exemptions given some businesses in our community work a definite hardship on other parts of the community.

In 1985 I worked as Chairman of the Washington Small Business Council's Committee on Unfair Business Competition and Contracting Out. Our work in 1985 led the Council and the Association of Washington Business's Board of Directors to the realization that we have problems in Washington not just with universities but with:

state run laundries bidding in the open market
marinas run by port districts competing with the private sector

county fair boards operating horse boarding stables
engineering laboratories competing with government run labs
charaties opening and operating restaurants and other food services
sheltered workshops using non-handicapped persons to fulfill contracts
won by competitive bidding in which they are given an advantage
health clubs operated as charities
+++++++++++++ and the list could go on.

In January, 1986, I raised the issue of unfair business competition during the Washington State White House Conference on Small Business Pre-Conference participants. Unfair competition was not even a scheduled agenda item. But at the close of the conference it was among the top ten issues to be taken from our state to the national conference.

At the August, 1986, conference the Unfair Competition issue was not a primary agenda item initially identified by conference staff and their advisory committees. It definitely became a primary item when over 70% of the delegations had the unfair competition issue in their agendas. It became clear to everyone that unfair competition from tax exempt businesses was a significant issue when the full conference identified it as the third most significant problem addressed at the White House Conference on Small Business.

Suddenly we, the small business persons, had caught the attention of the press, the public, and in Pullman the university administrators. In the fall of 1986, everyone was suddenly ready to admit that unfair business competition between the tax exempt university businesses and other businesses was a problem. There was, and their continues to be, disagreement on the exact definition of the problem and ways to find solutions.

Everyone in Pullman did agree that solutions must come on the local, state, and federal levels. The problem is very complex as are most problems that have developed over time. There are vested interests and guarded opinions on both sides of this issue. It is explosive, at least it is in Pullman. A variety of press clippings can attest to this fact.

First, and foremost, local solutions are necessary to the competition problems between tax exempt organizations and businesses. Pullman, a city of 22,000, has very different problems when considering the commercial activities of a university than does Seattle. The special rules of the game must fit the unique needs of the playing field.

Second, a procedure needs to be established that automatically removes the tax exempt status of an organization after a prescribed period of time. Tax exemptions must sunset for all organizations except true donative charaties. If a charity wishes to operate a business, have it operate under the same rules, same burdens, that are imposed on all other businesses. Granting of a tax exemption, or other special business advantages, must require proof from the applicant that their commercial activity relates directly to the organization's primary mission. Further, it would seem appropriate to question if there were other ways to attain the goals of the commercial activity, be it fund generation or putting low cost computers into the hands of students.

Third, tax exempt organizations should be prohibited from taking any advantage of their special tax status in bidding the sale of product and/or services to government or government contractors.

Lastly, it seems necessary that there be an examination of the motives and procedures of huge companies that entice tax exempt organizations to move into commercial business in the general market place.

Are there restrictions related to offering one price to one reseller and using a different price schedule for another because one is tax exempt and the other is not? Except for volume considerations should a computer or software manufacturer use a price schedule for me that is different that used for the university store? Both of our stores are selling to the same market. Is the manufacturer giving special advantages to the tax exempt organization to actually help that organization — or are they doing it for reasons related to market position and movement of product?

Any efforts to change tax status of commercial tax exempt organizations will bring howls of pain. There will be attacks on business persons that fight for equality — I can attest to that from my own situation in Pullman. I have been sworn at by university administrators, challenged in grocery stores by a faculty member about my position on the university computer store, and even called a pest in an editorial in a local paper because I asked a university administrator in a public meeting if they could use multiple award contracts or contract out to area businesses for services. I anticipate repercussions for my offering testimony to this committee. Rather than being called a pest in editorials I might be called a damn pest.

In February, 1986, concerned business persons affiliated with the Association of Washington Business submitted a bill to the Washington State Legislature that would have regulated business activities of colleges. The "...manager of the WSU Student's Book

Corporation said his store could lose as much as $3 million in annual sales if the bill, designed to limit competition between state colleges and universities, [made] it through the Legislature." (Idahonian/Daily News February 18, 1987, pages 1-10.)

The 1986 legislative efforts brought no results.

In our State for the 1987 legislative session the WSBC of the Association of Washington Business mounted a campaign addressing unfair competition. Three bills came before the legislature, one addressing the university commercial programs. Lobbying on both sides of the issues by businesses and the universities was intense. Forces were lined up to protect turf.

On February 16, 1987, the WSU Daily Evergreen (pages 1 & 2) carried an article with the headline, "Bookie's tax exempt standing threatened" in which the WSU-SBC manager is quoted as saying, "I fully expect that we'll lose [tax exempt status] eventually...." The manager went on to state that the loss of tax exemption could affect students in a very real way. Implied was a real doom-n-gloom outlook for the multi-million dollar retailer.

The argument was that the WSU-SBC passes its savings in taxes, and other benefits, on to buyers of textbooks (they extend a 4% to 6% discount) and makes grants to student activities. The press further confused the issue by mixing in-state concerns with federal taxation.

It was implied by a WSU administrator, when speaking of federal taxes, that if the WSU-SBC paid income taxes we would be sending $60,000 out of town — and that may not be desirable. (Pullman Herald February 18, 1987, page 10.)

Ultimately the issue became so foggy that everyone involved accepted a compromise bill known as SB-5688, An Act Relating to Commercial Activities of Higher Education.

SB-5688, which was overwhelmingly passed in both houses of our legislature, calls for the universities to meet with local business persons to develop a plan for finding solutions to the competition problem. The most important thing the bill accomplished is that it officially recognized that there is, indeed, a problem. The legislators are hopeful it can be locally solved. All parties are directed to report back to the Legislature by December 1, 1987, of successes and failures in attempting to find solutions. Though SB-5688 is a good bill it still fails to insure solutions to unfair business practices in which universities (or their agents) may engage. It is a start. We now have a five month window to try and find solutions in our state. If we do not find solutions we are back to the legislature as called for in the law.

Though SB-5688 is recognized as a starting point it definitely puts the small independent business person at a disadvantage. Build a picture in your mind of Harry Jones. Harry operates a printing and copying service. Harry is to take time from his five person shop to meet with a university vice president for business, university vice president for public and government relations, the university's attorney general representative, and Dr. Johnson the director of university printing and publishing services. They are to discuss the university as a printing competitor in the open market place and map out a plan to insure there is no unfair competition. The meeting takes place in the vice president's office — not at Harry's print shop. Harry did graduate from high school, but the world of of the university is foreign. Harry is intemidated by the process.

In Pullman there is a definite interest on the part of most university administrators to work through this problem to solution. Business persons want fair competition. Everyone in Pullman wants to further develop the positive interdependence that should exist between the city, its businesses, and the university.

An attitude of cooperation for community good permeates the community. But yet this unfair competition issue is hanging over everyone's head. And the granting of federal tax exemptions to selected businesses in our community is a part of the problem. And, from Pullman's standpoint, that is why the provisions on the Unrelated Business Income Tax need serious and prompt attention.

Over the past 12 months there has been a definite improvement in relationships in the computer retailing arena. The university store is still in business but there is now growing cooperation made possible by personnel changes. We hope solutions to marketing conflicts can be found — we think they can. But the question remains — should a university be in a position to operate a computer retailing business selling to users outside the university and (1) be free from all federal taxes and (2) should the disruption of a market be allowed under the claim it is a non-profit tax exempt organization doing the disrupting?

Locally we can address only so many of the problems. At the state level there are definite limitations to what can be done in giving one class of business a tax advantage over another. The federal tax statutes will set the pattern for change.

I respectfully request that three things be done at the federal level.

First, establish a program that sunsets all tax exemptions for commercial tax exempt type organizations every three years. Place the burden of proof on the organizations as they show a need for their commercial activity as a way to meet the primary role and mission of their organizations. Make the organization prove that they are in no way competing with businesses in the tax paying sector of the economy.

Second, eliminate the advantages enjoyed by not for profit and tax exempt organizations by charging an excise tax on all revenue earned through their selling to or contracting with the federal government or organizations with which the federal government has contracted. Reduce or eliminate the problem of having businesses pay taxes to fund their tax exempt competitors as these tax exempt businesses do business with government.

Third, establish a revenue procedure that collects taxes on unrelated business income. The stress here is on income and not profits. As has been shown the hiding of income in a large organization makes both income and profits nearly impossible to identify. In essence, all business activity would be taxed (profitable or not) if it could not be proven that the activity was not directly and substantially a part of the primary mission of the tax exempt organization.

College bookstores selling designer blue jeans, stereos, cosmetics, etc., would pay income taxes on those sales — sales of textbooks and classroom supplies called for by a professor would continue to be tax exempt income. Computers sold by a university store to a university department would be tax exempt but sales to individuals would be taxed as would a sale by any other reseller. And, if it is appropriate for this committee to question marketing practices, it needs to be known if differential pricing of merchandise sold at wholesale to a dealer for resale can have variable price schedules just because of the tax classification of the retailer.

As we look to the future we see significant changes related to tax exemptions. Business persons are optimistic about the establishment of fairness in the market place. As I look to the future I see Community Computer Centers continuing to do most of its sales away from Pullman through an outside sales program.

I see us being successful in our Chapter 11 reorganization and I see us being able to address our major creditors.

Believe it or not, we members of the small business community are willing to pay taxes. I did not say we wanted to pay them. But we are willing to pay taxes charged fairly against all businesses. If we are considering income taxes for businesses all income should be taxed whether it is related to its primary role or mission or not.

In closing please let me offer two comments.

Those of us affiliated with the Association of Washington Business, the Washington Small Business Council, the International Communications Industries Association, and those businesses that helped pay my way to this hearing believe in our free enterprise system. We support an open and free market. It is more important to stress that we support an open and _fair_ market place where all businesses can compete under the same rules, same tax burdens, and all businesses have the same starting point as we work to success.

And, as was demonstrated at the 1986 White House Conference on Small Business, we all believe in our nation's open and participatory system of government. We cherish the right of assembly in our business and trade associations and we are thankful we have maintained the right to address the leaders of our government on issues of importance.

On behalf of those that assisted in my appearance today I wish to thank the members of the Committee, and the Committee's staff, for this opportunity to share opinions and ideas.

Mr. FLIPPO. Thank you, Mr. Brong.

Mr. Johnson, would you proceed with your testimony.

STATEMENT OF JAMES WM JOHNSON, ASSOCIATE AND CHIEF EXECUTIVE OFFICER, AMADOR CORP.

Mr. JOHNSON. Good morning. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, my name is James Johnson, and I am genuinely pleased to be appearing before the subcommittee on behalf of Amador Corp., a company of which I am coowner and chief executive officer. I have already submitted testimony to the committee of a formal nature.

Amador Corp., is an independent, commercial taxpaying laboratory located in Minnesota. We number 18 employees. Our major business is performing electromagnetic compliance [EMC], tests of computers for companies such as IBM, Control Data, NCR, et cetera, and other electronic equipment according to the rules of the U.S. Federal Communications Commission, the FCC, the West German Verband Deutscher Elektrotechniker [VDE], and the Japanese Voluntary Control for Interference by Data Processing Equipment and Electronic Office Machines [VCCI].

I will cite very specific examples of an extremely capable nonprofit organization, Underwriters Laboratories, Inc., UL, who is expanding the scope of its business activities, business activities that should be taxed.

Underwriters Laboratories, UL, takes advantage of section 501(c)(3) of the code which recognizes "testing for the public safety" as an exempt activity. With the incentive of its tax- exempt status, UL is finding it quite profitable to add such additional services as FCC and VDE—that's the West German electromagnetic emission testing, which have little or nothing to do with their so-called exempt activity.

UL is even moving toward a monopolistic situation regarding the testing of products for the West German market. I want to make that clear, the West German market.

UL's VDE testing activity is for products engineered for the German market, tested to West German specifications for the safety of the West German people. I want to repeat that. Their VDE testing activity is for products engineered for the German market, tested to West German specifications for the safety of the West German people.

I would not mind competing against UL if the Tax Code were not so unfair in providing the major economic advantages. The chairman asked for some specific examples and a case history. Here is a specific example:

An example can be made by their new EMC open area test site that they recently installed in Northbrook, IL. Assuming that the facility, which is quite similar to our laboratory and function, costs $2 million, UL was not required to pay any sales tax on the construction materials, material handling equipment, et cetera, for this structure. The worst part of the contest is that Amador, my company, must go to the capital markets for its capitalization. We borrow money from the bank. Last year, we paid almost $100,000 in interest.

UL, to finance its excursions into businesses already occupied by taxpaying firms, has their huge amount of cash just setting around collecting interest. This gives them more than enough to outfit and build a facility to compete with Amador.

The competitive advantage, because of the current Tax Code, is about a quarter of a million dollars, and this doesn't include payment of income tax, or the lack thereof whatsoever. And now you see why UL can charge so much less than an independent laboratory such as Amador.

Another competitor of Amador, also a nonprofit and educational institution, who performs EMC's acceptability testing, said in a letter to me:

> However, deserved or not, some businesses and Government organizations are suspicious or have reservations about using private sector firms. Deserved or not, educational institutions are sought out by businesses specifically because the educational institutions are nonprofit.

The Tax Code has created a monster. We are operating against competition that is kept in its place and allowed to ravage markets by the laws of the lands. These laws desperately need changing.

Thank you very much, Mr. Chairman.

[The statement of Mr. Johnson follows:]

Statement of

James Wm Johnson

Associate and Chief Executive Officer

Amador Corporation

My name is James Wm Johnson and I am genuinely pleased to be appearing before the Subcommittee on behalf of Amador Corporation to review the U.S. Federal Government's tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code.

Amador Corporation is an independent, commercial, tax-paying laboratory located in Minnesota. Our major business is performing electromagnetic compliance tests of computers and other electronic equipment according to the rules of the U.S. Federal Communications Commission (FCC), the West German Verband Deutscher Elektrotechniker (VDE) and the Japanese Voluntary Control Council for Interference by Data Processing Equipment and Electronic Office Machines (VCCI). We are a U.S. National Bureau of Standards (NBS) accredited lab under their National Voluntary Laboratory Accreditation Program (NVLAP). Amador is proud to be active in the international arena; we have established a strong relationship with the VDE laboratory authorities in the area of radio frequency interference and, we are the only lab outside of Japan officially registered to perform tests according to the VCCI technical standards.

I am attaching as Appendices A & B two articles from the Minnesota-based press which explain more about our company and the technology with which we are involved.

The purpose of my testimony is to cite very specific examples of an extremely capable non-profit organization, Underwriters Laboratories, Inc., which is expanding the scope of its business activities that should be taxed. Some of the areas of business into which UL is entering are identical to those which Amador performs every day and on which we pay taxes. Lots of taxes, including corporate income taxes and sales taxes. The non-payment of taxes on the part of Underwriters Laboratories (UL) does not allow Amador's competitive efforts to be on the "level playing field" with this already very tough competitor.

I hope to demonstrate that because UL is a highly esteemed institution they very easily justify their presence in our marketplace. However, this is a marketplace that existed prior to their entry, and a marketplace that plainly does not need UL.

Underwriters Laboratories takes advantage of Section 501(c)(3) of the Code which recognizes "testing for the public safety" as an exempt activity. With the incentive of its tax-exempt status, UL is finding it quite "profitable" to add such additional services as FCC- and VDE-electromagnetic emission testing which have little or nothing to do with their exempt activity.

In a featured story in the Small Business column of the November 10, 1986 Wall Street Journal, we read:

> "...UL has become more aggressive in seeking clients and new areas of business."

Amador does not take these new incursions lying down, even though our colleagues in the testing business have advised us that recriminations from UL to our small firm are inevitable. Amador submitted a position paper to Mr. Jack Bono, the President of UL, on April 2, 1985 requesting that this document be distributed to the Board of Directors (sic). This position paper is Appendix C. It clearly outlines the situation with regard to a new UL business activity, electromagnetic compatibility (EMC) testing of large equipment in the Midwest. As you will see from the resultant letter to me from Mr. Jack Bono, found in Appendix D:

> "I presented those views to the Executive Committee of our Board of Trustees."
> (Note even the use of the term "Board of Trustees" versus the more typical "Board of Directors" employed by tax-paying corporations in order to maintain the peculiar aura of a non-profit.)

My "views" can be summarized.

UL TRIES TO MONOPOLIZE STILL ANOTHER "SAFETY" TESTING AREA

UL, by building this new EMC Northbrook facility is attempting to preempt independent labs from their rightful place in the business of compliance testing. Further, UL is moving towards a monopolistic situation regarding the testing of products for the West German market. They already have at least one other monopoly.

Their latest annual report reads:

> "(UL) is the only standards-making product safety certification agency in the U.S."

The American National Standards Institute (ANSI) is the standards-making body for EMC. UL would change that. We recognize, as I experienced in a conversation with UL, that they would also change Amador. In the words of the Chairman of UL's Executive Committee Robert J. Haugh,

> "Has UL put you (Amador) out of business?"

Government and industry combined are raising the standards of EMC testing. UL did nothing to aid, and in the opinion of some both within and outside of government, did everything possible to discourage the introduction of the National Bureau of Standard's accreditation program for EMC labs. UL's extensive lobbying efforts did not work. After the adoption of the NVLAP, UL then joined the program with the tax-paying labs.

UL CONDUCTS TESTING FOR FOREIGN MARKETS AND PAYS NO TAXES

In my position paper, I cited the fact that UL should not engage in a monopolistic arrangement with the West German authorities to enable UL to test equipment destined for the foreign markets. (Often this equipment is not even American-made.) In fact, after the receipt of my "views," UL did consummate an arrangement with VDE which in their newsletter reads as follows:

> "UL, VDE ...
>
> Normally, VDE would conduct the investigations and authorize use of the GS-mark (the mark used for compliance-identification in Germany). Under the new agreements, manufacturers may submit their products directly to UL who will process them through the VDE certification systems.
>
> UL will investigate the products in accordance with the applicable German standards, as would VDE."

This activity is for products engineered for the German market, tested to West German specifications for the "safety" of the West German people. As I have noted, there may, in fact, be no American entities involved at all, other than the UL technicians testing the gear under the protection of the

U.S. tax laws. The revenue UL makes for this service to the West Germans has not been subject to U.S. Federal income tax.

When UL has been granted the blessing of the Federal Government of non-profit status, UL can see everything in the world be related to safety. I call the committee's attention to the logic of Mr. Bono's letter to me of January 30, 1987.

> "UL's approach has always been to evaluate products from the standpoint of all reasonably foreseeable risks."

This philosophy gives them, in effect, carte blanche to enter any testing arena they desire. For who among us could not find some risk in virtually every function of an electronic device. Where, under the current tax laws, are their any controls on such activities? What can possibly stop them from continuing to systematically take over the entire electrical and electronic testing markets?

But I would not mind competing against them, if the tax code was not so unfair in providing major economic advantages. A specific example can be made with their open area test site operation they recently installed in Northbrook. This is the same facility I have highlighted in my position paper.

Assuming for the moment that the facility (which is quite similar to our laboratory in function) costs $2 million. UL was not required to pay any sales tax on the construction materials, material handling equipment, etc. for this structure. Assuming the cost of materials is 50% and that the sales tax is 6%. This is competitive edge of $60,000 over our tax-paying firm. Equipment to run the tests is very expensive. Amador has approximately $600,000 in equipment for which we must pay a sales tax. UL pays no sales tax. This is another $36,000 advantage. Amador pays the full rate for postage. And so it goes. But the worst part of the contest, is that Amador must go to the capital markets for its capitalization. We borrow money from the bank. Last year we paid almost $100,000 in interest. UL, to finance its excursions into businesses already occupied by tax-paying firms has their huge cache of cash just sitting around collecting interest. (The interest they collect a year on retained earnings was $5,000,000 last year.) This gives them more than enough to outfit and build a facility to compete with Amador. The competitive advantage because of the current tax code is around a quarter of a million dollars. And now you can see why UL can charge less than independent tax-paying laboratories such as Amador.

NON PROFITS CLAIM THEIR CLIENTS ASK FOR THEIR SERVICES

In a meeting with Mr. Bono, he stated that UL's clients have asked them to go into EMC. This is a common theme among non-profit organizations. Another competitor of Amador, also a non-profit, an educational lab who performs EMC susceptibility testing said in a letter to me:

> "However, deserved or not, some businesses and government organizations are suspicious or have reservations about using private sector firms. Deserved or not, educational institutions are sought out by businesses specifically because the educational institutions are non-profit." (Emphasis mine.)

The tax code has created a monster. And yet Amador counts amongst its clients IBM, Medtronic, CDC, NCR, Unisys and other companies important in the U.S. economy. We have paying taxes. But we are operating against competition that is kept in its place and allowed to ravage markets by the laws of the land. These laws need changing. These non-profit organizations no doubt will survive. But certain of these operations should only survive if the market-place allows them to. That is the only way Amador will survive. By the actions of the marketplace. That is the American system and I, for one, would not have it any other way.

APPENDIX A

MINNESOTA
ROUNDUP AMADOR CORPORATION/ALMELUND

Minimizing Interference in the Workplace

Employees who get paid to cross country ski, jog, or play volleyball. Lunches featuring such delicacies as Swedish meatballs and rice pudding which are catered daily to the company lunchroom. No job titles, no job descriptions, no performance appraisals.

No, that's not a thumbnail sketch of the latest trendy management theory. It's the modus operandi for Amador Corporation, a Control Data spin-off that is as unusual for its operating style as it is for its barn-like building and its purposefully remote location in Almelund, Minnesota, about an hour's drive northeast of the Twin Cities.

The company's unorthodox operating practices reflect the leadership of James Johnson, CEO and cofounder of Amador, which tests computers and other electronics equipment to ensure they don't produce illegal electromagnetic interference.

Amador's secluded location in the rocky terrain of the St. Croix River Valley is ideal for obtaining accurate readings of electromagnetic signals from products because the valley screens out most radio broadcasts and other outside interference. The readings take place in a barn-like building, whose top half consists of the same plastic material used to cover the Metrodome.

Johnson, an engaging, thoughtful man who favors suspenders and turtlenecks over three-piece suits and starched shirts, says Amador's sales have been growing at a 20-percent annual clip since the company was founded in September 1984. Johnson, who says Amador is turning a profit, expects sales to top $1 million for the company's 1986 fiscal year, which ends June 30.

Amador's clients include CPT Corporation, Honeywell, Sperry, and 3M. The company's international clientele now includes firms from West Germany, Brazil, and eight other countries.

Johnson and Daniel Hoolihan, chief operating officer and the other owner of Amador, are pleased with their company's progress. But Johnson says he's just as pleased that Amador's loosely-structured work environment has been a hit with his nine full-time and eight part-time "associates"—Amador's word for employees.

"Huge areas of the business are run by consensus. It's great and the people love it," says Johnson, who adds that Amador's out-of-the-way locale has not resulted in a shortage of job applications.

James Johnson, Daniel Hoolihan: just a couple of associates.

Johnson's management philosophy is more than two decades in the making. A native of St. Paul, Johnson graduated from the College of St. Thomas in 1962. After graduation he landed a job with 3M, selling computer controlled reflective products. He obtained his MBA degree from Columbia University in 1969.

Following his graduation from Columbia, Johnson returned to 3M, serving as business manager and then a divisional marketing manager. From 1981 to 1984 he worked as a director of new business development and then as a general manager for electrostatic discharge and protective materials operations for Bemis Company.

Johnson and Hoolihan launched Amador when Control Data sold its underutilized Almelund facility. The transaction called for the two men to pay CDC $1.2 million, which Johnson and Hoolihan financed with a bank loan, and a three-year agreement with CDC to test its equipment. The company's name comes from Amador Township, which surrounds the firm.

From the start, Johnson put into effect his unconventional management practices. To name just a few: Employees are paid half their wage for the time they spend exercising, whether it be cross country skiing at the adjoining Wild River State Park or playing volleyball just a few steps outside the company's front door; many policy decisions, including those involving sick leave, are determined by the majority of the employees; no one reports to anybody else, and there are no job titles or salary reviews.

In some respects those practices are in direct contrast to the planned, systematic practices of large companies. "Having come from a large corporation where you have these things, which I felt in many cases were dehumanizing, I didn't want to focus on the negatives," Johnson says.

"There's so much B.S. in an organization, with the boss as supervisor, executive power, ruling by fear. I've just seen where this doesn't lead to a conducive work environment," he says.

The immediate goals for Amador are to expand its customer base. Johnson says that will probably include testing of general consumer products, such as telephones, appliances, and fluorescent lighting. Amador, which is already doing some testing for the Defense Department, is also exploring testing of medical equipment.

Another goal of the company is to continue its informal work environment, Johnson says: "The true test is, can we keep this atmosphere going; can we keep it from going stale? I think we can, because the people are creative, and the environment is dynamic."

Minnesota Business Journal May 1986

Minneapolis STAR and Tribune Thursday
March 5, 1987

Computers and technology/

Staff Photo by Joey McLeister

The Amador Corp. is tucked in on a dirt road near Taylors Falls where its employees can listen for the faint sounds of the new computer equipment they test for compliance with FCC standards.

Company one of few in nation equipped to hear circuit leaks

Technology

Steve Gross

Taylors Falls, Minn.
On the quiet poplar and birch-lined hills above the St. Croix River, where deer and rabbit tracks outnumber footprints, people are listening for sounds not audible to the human ear.

They work for Amador Corp., a 12-employee company almost hidden on a dirt road 8 miles from Taylors Falls. A mile from Amador's nearest neighbor, the Wild Mountain ski area, employees are using antennas to listen for the faint sounds of electronic noise.

The noise comes from new computer equipment that Amador is testing. Nearly all new equipment has small "leaks" in its circuits, which release electronic noise with each split-second tick of the computer's electronic clock. The Federal Communications Commission (FCC) has set standards for the amount of noise that computer equipment is allowed to emit, and Amador was formed in 1984 to pinpoint electronic leaks for companies seeking to comply with the FCC rules.

Although the escaping noise is too weak to affect humans, it can disturb other computers or TV sets from as far as 90 feet away, said James Johnson, one of two partners in the privately owned Amador.

He said Amador was located in this remote area of Chisago County to escape the Minneapolis-St. Paul area, where the faint electronic noises would be drowned out by a cacophony of radio and TV broadcasts, aircraft-to-ground radio communications, above-ground power lines, which produce strong electric fields, and even pickup trucks with badly out-of-tune spark plugs.

But in Amador Twp., for which the firm is named, the electronic rum-

Gross continued on page 4M

Gross Continued from page 1M

ble of the Twin Cities is muted. Some radio and TV signals are reflected by the hills surrounding the St. Croix valley, and some are absorbed by the trees, Johnson said. Commercial planes don't fly over the area, and the dirt road is far enough away that truck engines don't pose a problem, he said. That makes Amador's location nearly ideal, and Amador took pains to keep it that way by burying its power lines.

This week Amador's second-floor laboratory contained a new IBM computer printer, which was being rotated on a 22-foot turntable so that its electronic noise emissions could be measured from all angles by two antennas resembling eggbeaters. The closer antenna is 9 feet away inside the building, while the other is 90 feet away outside the lab. The more distant antenna still can hear the printer's noise because the laboratory is covered with a roof of flexible, tent-like material that the electronic signals can pass through.

In a room on the first floor, an engineer and a technician monitored the electronic noise from the printer and tried to determine which of the machine's circuits was producing the leak. Armed with that information, Amador will advise IBM how to fix the circuits so the printer will comply with FCC rules.

Johnson said 30 to 40 percent of the new equipment it tests fails to comply with the FCC rules and must be modified. That provides Amador with plenty of work, for which it charges $2,500 per eight-hour daytime shift and $1,200 per night shift. Johnson declined to say how much the firm earns, but said it was profitable last year on revenues of $1.25 million.

Amador isn't the only company performing this type of testing, but it appears to have only a few competitors nationwide. Its nearest rival, Norand Corp. of Cedar Rapids, Iowa, said there are only 13 firms nationwide capable of performing the tests. In the Midwest there are only Amador, Norand and two Chicago companies, said Mike Howard, supervisor of Norand's testing laboratory.

One reason for the scarcity of competitors may be the precision needed to measure electronic noise, which is detected as tiny fluctuations in the electric field surrounding a piece of computer equipment.

"Typically the FM radio signal that comes into your house in the Minneapolis-St. Paul area is 10 times as strong as the signal (that) the average computer gives off," Johnson said.

Another problem is finding a suitable location. Johnson said Control Data Corp., from whom he and partner Dan Hoolihan bought the laboratory for $1.2 million three years ago, considered 26 locations in the state before settling on rural Taylors Falls.

Control Data, which was testing its own equipment at the lab, sold it to Amador shortly after building the lab because it was underutilized, he said. Amador solved that problem by offering testing services to many companies. It now has about 150 customers; IBM and Control Data are the most frequent, he said.

Staff Photo by Joey McLeister

James Johnson, a partner in Amador: The escaping noise is too weak to affect humans, but it can disturb other computers or TV sets.

In an attempt to tap the growing medical electronics business in the Twin Cities, Amador plans to open a different type of testing lab in the Twin Cities next month. Rather than measure noise, the lab will measure the resistance of products such as heart pacemakers to outside electronic radiation, Johnson said. That electronic bombardment is performed within a special copper-shielded room, but doesn't require the electronic silence found near Taylors Falls.

For the future, Johnson said the biggest threat to Amador's quiet surroundings is a high-voltage power line that Northern States Power Co. is considering for the area in the 1990s, a project that Amador opposes. Other development near Amador's 17-acre tract is forestalled by zoning regulations because much of the land is part of a National Scenic Waterway area, he said.

Looking out his office window at the tree-lined horizon of Wisconsin just across the St. Croix River, he added, "We're really sequestered in here. It's just marvelous."

APPENDIX C

AMADOR'S POSITION PAPER TO UL RE: NORTHBROOK EMC SITE

Position paper on UL constructing an all weather EMI lab in Northbrook, Illinois

Summary

Amador Corporation (Amador), an independent Electromagnetic Compatibility (EMC) lab located in the Midwest respectfully submits that Underwriters Laboratories Inc. (UL) not construct an all weather Federal Communication Commission (FCC) Part 15.J (EMI) Lab in Northbrook, Illinois.

Midwest electronics firms are presently served by five (5) EMI labs in the Midwest. Current and projected new product development (and therefore EMI testing demand), will be relatively constant because of the reduced number of firms requiring EMC testing. Demand at UL's EMI lab in Melville has not been of sufficient quantity to justify construction of the Northbrook lab (an apparent precondition outlined in UL publicity). Enhanced UL capacity gives credence to the UL position that independent EMC labs be preempted to participating in any new FCC strategy vis-a-vis type acceptance, certification, etc. Likewise, increased UL capacity "justifies" further expansion into "laboratory testing greatly removed from public safety," e.g., electromagnetic susceptibility testing. UL's facility in Northbrook could only be viewed as a predatory move to monopolize West German (VDE) testing performed in North America. Lastly, Amador encourages UL to respond to the NBS NVLAP EMC lab petition.

Overcapacity of Midwest EMC labs the current and projected situation

Five (5) labs, four (4) in the Chicago area and one (1) in Minnesota, presently offer the same or superior level of testing services than the UL Northbrook lab is proposing to offer.

While there was a flurry of activity around the date the FCC EMI rules became effective (November, 1983), the highly touted "fall out" of microcomputer manufacturers has indeed reduced the total number potential firms substantially. Labs surveyed in this area currently have a substantial overcapacity. UL's facility would exasperate this situation.

Art Wall of the FCC has told Amador that "several hundred" labs are awaiting FCC Registration at this time. Today, across the country, there are approximately 200 labs registered with the FCC for EMI testing.

Melville's EMI Facility has not developed beyond its capacity

A UL communication reads: "The Northbrook property offers the opportunity for expansion *if* the work load at Melville develops beyond its capacity." (Emphasis mine.)

Our best information is that Melville is not "beyond its capacity." Second, practitioners would take serious exception to the judgment that the Northbrook property would be appropriate for an open field site because of the ambient. As you are aware, our facility, and D.L.S. Electronics are situated a substantial distance from TV sources to preclude the ambient problem.

Independent labs question UL's long-range strategy on electronic testing of all types

At the March 22, 1985 meeting with Mr. Jack Bono, Mr. Bono expressed two (2) consistent themes which, taken at their full value, cause significant consternation with independent labs. Paraphrasing them, they would read:

1. "EMI testing is safety testing."

   Amador rejects the "safety" arguement as a smoke-screen of UL's to expand its horizons into areas where for-profit independent labs are are adequately servicing their customers.

   With this logic all electronic testing would be within the domain of UL; ATE, circuit board testing, etc. Amador submits on the black-to-white scale of the "public safety" continuum, EMI testing is becoming very gray. EMC testing practioners are very cautious in outlining life-threatening implications to EMI. Communication difficulties, yes. Life-or-death problems, no.

2. "Our clients have asked us to go into EMI testing."

   Given UL's charter of not assisting your clients on how to design their products, i.e., no consulting; and, given, that there are a number of quality labs of adequately servicing their customers, may we politely suggest that UL offer their client's the names of labs capable of providing the EMI service. The FCC list of Registered labs would be an appropriate summary of available labs.

Construction of the Northbrook site would aid UL in its predatory bid to monopolize the West German testing facility Verband Deutscher Elektrotechniker (VDE) testing in America

As noted in the minutes from the CBEMA/UL Liaison Committee Meeting of November 8, 1984:

> "UL was working with VDE to achieve specific recognition by VDE to allow UL to conduct the VDE tests for American manufacturers." (Emphasis mine.)

I personally visited the VDE in Offenbach, West Germany in January, 1985, expressly to have this relationship defined. Dr. Warner, the leader of the VDE test house assured me that such an arrangement (such as described by the CBEMA minutes) is not in accordance with VDE's established policies.

Today Amador has similar EMC-testing privileges vis-a-vis the VDE as UL, viz., the VDE test team comes to the U.S. and actually performs the test for the American client. If UL were given this "specific recognition" to the exclusion of Amador and other EMI labs performing these tests, it would be a major defeat for independent EMI Labs in the U.S.

Mr. Bono, again at our meeeting, attempted to represent an equivalency between VDE and UL in these matters. This logic is flawed. As I pointed out to Mr. Bono, VDE encourages the participation and the growth of testing and consulting labs such as Amador. UL's participation in EMI testing, especially VDE testing, is directly counter to Amador's existence!

UL's pricing would reflect a subsidization by UL and would be less expensive than Amador's

Mr. Seelbach represented that the UL pricing at Melville was $1700 per shift. Testing at Amador, including a test report, is priced at $2400 per day shift at the large site.

UL's lack of providing "full service" runs counter to the policy of the FCC

At my recent visit to the FCC Lab in February, concern was expressed by the FCC personnel that Amador give the smaller companies design assistance in addition to the testing service to aid in FCC EMI compliance.

UL has expressed that its policy of "hands-off" will pervail in the area of EMC. Given the naivete of the small-firm customers and the narrow window of opportunity available to (particularly) the new firm, this policy is not in the best general interest. In short, if UL cannot help the customer, you should not be in this EMC business.

All weather open field construction is capital-intensive This capital investment is required for EMC consulting

In order for Amador to perform the EMI testing, approximately $1.5 million has been spent on capital investments. "Consulting only" cannot begin to pay for this investment. Testing and open field consulting go hand-in-hand. A scenario of Amador (and firms like them) performing the design professional work, and UL performing the testing ("cherry-picking") shows a lack of understanding of the basic economics and engineering realities of EMC. If UL dominates the field (as it does in Product Safety), small firms like Amador who service the smaller electronic firms may be driven out of the market place. Large firms who have adequate EMC engineering would be at an advantage over the smaller firms. Without a test site, "value-engineering" and similar consulting is plainly not possible.

A laboratory accreditation program would best enable the nation's electronic firms to compete globally

The National Bureau of Standards (NBS) has requested comments in order to establish a national laboratory accreditation program (LAP) under the National Voluntary Laboratory Accreditation Program (NVLAP).

UL, according Mr. Poggi, the EMI Lab requester, has filed a comment of "no comment." While I have never met Mr. Poggi, he apparently feels that UL should be taking a progressive attitude about such a program. I must agree! Amador will be filing comments to the NBS. May we encourage you to do likewise.

Conclusion

For all of the above reasons, Amador respectively submits that the UL Board of Directors reject the staff proposal to a Northbrook EMC site.

Respectfully submitted

James Wm Johnson

APPENDIX D

UNDERWRITERS LABORATORIES INC.
333 PFINGSTEN ROAD NORTHBROOK, ILLINOIS 60062
an independent, not-for-profit organization testing for public safety

January 30, 1986

Mr. James W. Johnson
Amador Corporation
Wild Mountain Road
Almelund, MN 55002

Dear Mr. Johnson:

Thank you for sending me a copy of your letter dated January 23, 1986 to Mr. Robert Haugh, once again expressing your views concerning UL's plan to construct an EMI test facility in Northbrook. Recent events have reinforced our original position that a comprehensive safety evaluation in a number of product areas requires that UL have the knowledge and capability to conduct EMI testing and, in fact, deal with the entire matter of compatibility of RF signals.

We are far beyond the radio-controlled garage door operator. Bedside consoles now utilize radio frequencies to control all lights and some appliances on the premises. Radio frequency signals sent through the air from the utility plant now turn on thousands of water heaters at off peak times. Energy management equipment of all types are utilizing radio frequencies to perform their functions. Appliances are being designed with built-in microprocessors to self-diagnose problems and to turn on or off in response to a remote RF signal.

UL is participating in committees studying the design and introduction of so-called "smart houses" and "intelligent buildings." These will involve power distribution systems with a computer to control power distribution according to demand. Upon receiving a signal of the need for an appliance to be operated, the computer would determine the condition of the load on the electrical run to that appliance, select the best possible routing of the load and apply power to the appliance.

There will be RF signals turning things on and off and development of an orderly system of signal generation and discrimination against unwanted signals will be essential. These new and innovative developments will introduce safety considerations. For example, a wireless telephone may inadvertently turn on a coffee maker or some other appliance.

Throughout UL's 92-year history, we have had to look ahead to the effects of new technology on product safety. When radiation became a matter of concern with appliances and medical equipment, we had to equip ourselves to make the proper measurements for this potential hazard. When electronics were substituted for electrical and electromechanical devices, we had to prepare to conduct the stress testing and other approaches to determination of reliability.

UL's approach has always been to evaluate products from the standpoint of all reasonably foreseeable risks. There is no question that product performance in many areas will be affected by RF signals. We must be prepared to deal with this development.

As I promised you when you prepared the position paper objecting to UL's plans to construct an EMI facility in Northbrook, I presented those views to the Executive Committee of our Board of Trustees. Your views were not persuasive, either to me or to the Executive Committee.

I recognize that these statements may not represent a significantly different view than I had expressed in my previous discussions with you. I have not tried to respond to each point made in your presentation because it is inappropriate to do so, particularly those relating to pricing policies. I also believe that some of the positions which you expressed, such as the impact of UL's decision on your relationship with VDE, are highly speculative. I still believe that the important issue here is the validity of the basis for UL's involvement in this test area and I must repeat that developments since our previous communications substantiate the importance of UL's involvement.

Very truly yours,

Jack Bono

JACK BONO
President

JAB:AGA

CC: Mr. R. J. Haugh, Mr. R. W. Seelbach

UNDERWRITERS LABORATORIES INC.
333 PFINGSTEN ROAD · NORTHBROOK, ILLINOIS 60062

an independent, not-for-profit organization testing for public safety

RECEIVED JUL 13 1987

IT'S WHAT'S BEHIND THE TEST
THAT COUNTS...

Lee Data Corp.
c/o Product Safety Corp.
Mr. N. Devine
8660 State Hwy. 7
P. O. Box 666
St. Bonifacius, MN 55375

Dear Mr. Devine:

UL will open its new EMI facility at Northbrook this summer.

In addition to UL safety investigations, you'll now have the added convenience of EMI compliance testing -- all at one familiar location, from the most recognized and trusted name in product testing.

From the outset, you'll deal directly with engineers and technicians who understand what it takes to get your product to market. Our new EMI Services are designed with you in mind. They'll provide you with:

* RELIABLE SERVICE -- UL EMI staff is dedicated to provide the best service for FCC Parts 15 and 18 compliance and VDE measurements. We'll even develop special test applications to suit your needs.

* FLEXIBLE SCHEDULING -- Year-round operations make UL a truly flexible EMI alternative. Call us to set our schedule to meet your deadlines. Evening test hours are available for special situations.

* RESULTS YOU CAN TRUST -- Our all-plastic facility contains the latest in EMI test and measurement equipment. Get results you can depend on, quickly and economically.

* TECHNICAL ASSISTANCE -- Our staff is experienced in compliance testing and standards interpretation and application. Let us help you with EMI standards, regulations and submission procedures for the U.S. and abroad.

* EASY PRODUCT ADJUSTMENTS -- If your product needs adjustment during a test, fix it right on the spot. You'll have access to a workbench, tools and an assortment of filters, wiring and other parts to get the job done.

After all, you're concerned about compliance, and so are we. It's been our business for 93 years. No other testing organization can offer as much.

For more information on how we can help get your product to market, give me a call at 312/272-8800, extension 3258 ... or just complete and return the enclosed card, and I'll call you.

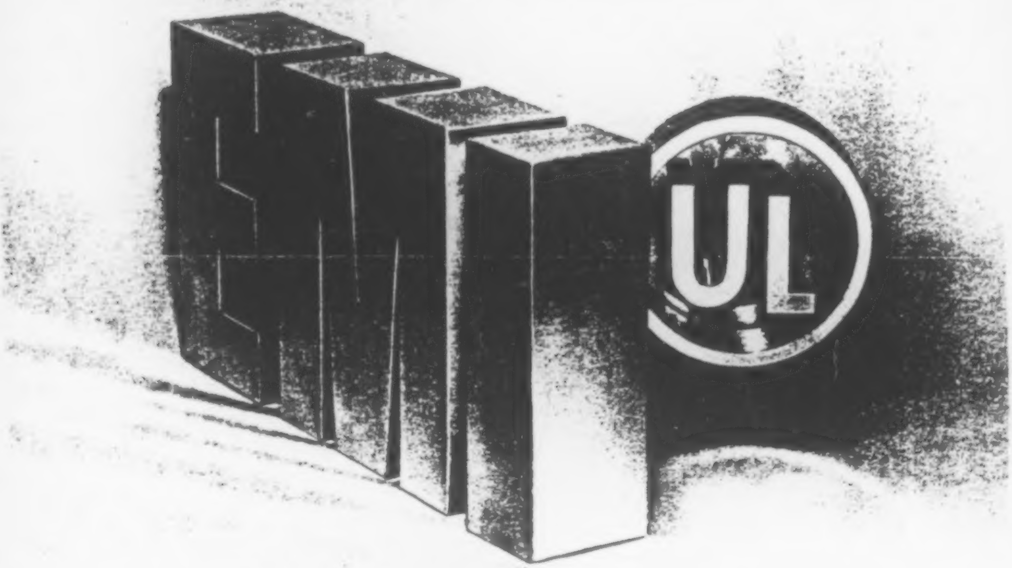
I'm looking forward to working with you on your next EMI project.

Sincerely,

Kurt Stefans

Kurt Stefans
EMI Services Coordinator

COMING SOON



It's what's behind the test that counts...

Compliance testing is important. It has to be quick, yet reliable. Performed by someone you can trust.

Underwriters Laboratories has been helping manufacturers bring their products to market for 93 years.

No other safety testing organization can offer as much.

☐ FCC compliance to Parts 15 and 18
☐ Testing to VDE EMI standards
☐ Technical assistance on EMI standards, regulations and submission procedures

For more information ask for the EMI Services Coordinator

UNDERWRITERS LABORATORIES INC.
333 Pfingsten Road
Northbrook, Illinois 60062
312/272-8800, Ext. 3258

Mr. Flippo. Thank you, Mr. Johnson.

Mr. Williams.

STATEMENT OF GROVER C. WILLIAMS, PRESIDENT, AMERICAN COUNCIL OF INDEPENDENT LABORATORIES, AND PRESIDENT, TRINITY ENGINEERING TESTING CORP., AUSTIN, TX

Mr. Williams. Mr. Chairman and members of the subcommittee, my written testimony has been submitted in detail previously to the subcommittee. I will attempt to summarize and make some of the points that I think are important.

My name is Grover Williams. I am president of the American Council of Independent Laboratories, a national association of commercial taxpaying laboratories engaged in testing, inspection, analysis and research for outside clients, both governmental and private. I have been active in the for-profit testing business for over 36 years.

I am president of a construction materials engineering testing firm with approximately 200 employees.

The weaknesses in the unrelated business income tax law, the broad interpretations of exemptions, and the difficulties of administering the law have created significant problems for our industry. The reported 1985 revenues of tax-exempt organizations exceed $300 billion.

Our best estimate of the portion of this 300 billion plus dollars that can be attributed to the research and testing activities of the commercial nonprofits is $25 to $30 billion.

The for-profit testing industry of approximately 4,000 businesses with 10,000 laboratory facilities generates about $6 billion a year. This imbalance is further aggravated by exempting from the Tax Code organizations that test for the public safety. One well-known and respected laboratory exempted from Federal income tax on the basis of testing for public safety reported a 1984 income of $116.7 million from the sale of services. They earned an additional $5.3 million in dividends and interest from investing some of their surplus income. This is a financially strong, technically competent corporation that is fully capable of competing on their own merits without help or subsidy from any source.

The 1984 nonprofit tax form 990 of this laboratory reported excess income over expenses of $16.7 million. And, gentlemen, my stockholders consider excess income over expenses as profit.

The change in this nonprofit laboratory's net worth for the year was a healthy increase of $12.6 million. And that's not too shabby for an underdog laboratory in need of a subsidy.

Two-thirds of the 1984 revenue was spent on salary costs, and that's about 20 to 25 percent higher than for-profit taxpaying organizations.

Contributions to retirement benefits of this laboratory amounted to $12.7 million in 1984. And I submit to this subcommittee that this form 990 was not filed by a struggling organization of charitable, civic-minded volunteers.

I can testify from personal experience these folks are stout. Elimination of the present exemption in the code for testing for the public safety would not prevent this laboratory from continuing to provide the same commercial services and be highly successful in the process.

My perception of the rationale for nonprofit tax exemption is that there must be uniqueness and a public need that cannot be financed by ordinary business arrangements because of the limited commercial value of the exempted activity.

Routine services offered to the public for a fee that more than compensates for the cost is not unique nor in the public interest, especially when these services are already available from the for-profit taxpaying sector.

The broad interpretation of relatedness, as an example, encourages the movement from basic research on a new material to the routine testing of products made from that material, although the justification for the original exemption would no longer apply.

We would recommend to this subcommittee that relatedness be more narrowly defined to prevent the commercialization of tax-exempt activities that compete directly and unfairly with taxpaying for-profit businesses.

Commercializing by tax-exempt organizations is why we are here. The General Accounting Office's report on competition between taxable businesses and tax-exempt organizations points out that 82 percent of the independent laboratories surveyed face competition from more than one nonprofit.

We would recommend close scrutiny of exclusions in the present unrelated business income tax law, and the elimination of blanket exemptions for fundamental research that is performed for proprietary reasons.

We also recommend a tighter, more clear definition of the exemptions for scientific purposes.

Finally, we would recommend that IRS be given greater responsibility in the determination of tax-exempt status. We ask Congress to provide equities to the for-profit companies and to establish rules that apply even-handedly to all parties engaged in commercial enterprise.

Henry Hansmann, a professor at Yale-Law School, made this very pertinent observation.

> The nonprofit sector represents a substantial and growing share of the national economy. Large concentrations of nonprofits can be found in a number of vital and expanding service industries, including education, health care, research, the media, and the arts. Nonprofit firms now commonly provide goods and services in direct competition with profit seeking firms and, in many cases, increasingly resemble their for-profit competitors in the manner of organization and operation.
>
> The traditional criteria for applying exemption are, as a result, being stretched beyond recognition.

Mr. Chairman and members of the subcommittee, I appreciate your attention.

[The statement of Mr. Williams follows:]

Testimony of

Grover Williams

President

American Council of Independent Laboratories

My name is Grover Williams and I am pleased to have an opportunity to appear before the Subcommittee on behalf of the American Council of Independent Laboratories ("ACIL") to review the federal tax treatment of commercial and other income-producing activities of organizations that have tax exempt status under Section 501 of the Internal Revenue Code. I am President of ACIL and President of Trinity Engineering Testing Corporation in Austin, Texas.

ACIL is an association of independent, commercial, tax-paying laboratories engaged in testing, analysis and research for outside clients, both governmental and private. Founded in 1937, the association represents over 325 of the nation's leading scientific and technical laboratories. These laboratories, mostly small businesses, cover a wide range of technical testing disciplines, including acoustic, biological, chemical analysis, electrical, mechanical, meteorological, non-destructive, optics/photometric and thermal. Attached as an appendix to my testimony is a detailed breakdown of the specific services covered within these disciplines (Tab 1).

The problem of tax-favored competition has plagued independent laboratories for many years. Since World War II, ACIL has observed unfair competition from nonprofits growing in scope and intensity. While ACIL does not claim to have as much data or information as it would like on the nature and dimensions of the problem, we believe that efforts to characterize evidence of the problem as anecdotal are misplaced. In specific areas of activity, including laboratory services, the evidence is overwhelming that nonprofits have been in a position to take advantage of the present tax laws to gain a significant competitive market share, and in some cases become a dominant factor in an area of commercial activity.

These commercial nonprofit organizations are often extremely capable in their fields of commercial activity and deserve their high reputation for excellence. Curing the laxness of the Internal Revenue Service in enforcing the present laws effectively, or modifying existing laws where they are inadequate, is not the responsibility of the nonprofit beneficiaries of the present system. Understandably, nonprofit organizations operating within the law will take every advantage of their tax-favored status to pursue their legitimate and often worthy goals. The issue for this Subcommittee to consider is whether certain classes of nonprofit organizations should be tax exempt at all, or if tax exempt, to what extent that part of their activities which is commercial in character should be taxed.

To focus on how IRS administers the present law, it is instructive to analyze selected large, representative, and nationally prominent, tax-exempt organizations. One such organization is the National Geographic Society. We can all agree that it represents a fine institution and publishes one of the leading magazines in the world. What may be less apparent is that the National Geographic has in the last twenty-five years become a big and lucrative business. The National Geographic Magazine has the third largest circulation in the United States. The Society is the 15th largest mail order house in America. By 1984, the National Geographic Society was grossing $326.8 million, had a net worth of at least $198 million and recorded "profits" of more than $17 million annually. Why is the National Geographic Society considered a tax-exempt organization? For what educational or charitable purpose does it exist? A recent article in the Washington Post provides a provocative description of how the present tax laws have been used to allow the Society to operate according to different rules than those followed by its competition -- commercial book and magazine publishers, atlas and globe makers, record producers and others (Tab 2).

Similarly, private tax-paying laboratories have experienced unfair competition from tax-exempt organizations providing laboratory services that is sweeping and devastating in scope and character. I will in my testimony:

- Provide a description of commercial activities by tax-exempt organizations unfairly competing with private independent laboratories, principally under the guise of "scientific" research and "testing for the public safety," including selected case histories.
- Consider the extent to which the present laws are inadequate to deal with these competitive inequities.
- Offer recommendations to improve the laws, policies and practices governing this competition and eliminate unfair practices.

I. DEFINITION OF TERMS AND PROFILE OF TAX-EXEMPT ORGANIZATION ACTIVITIES

The public discussion of the problem of tax favored competition has been greatly complicated by the difficulty in finding a common language to identify areas of potential and real abuses and the understandable concern of legitimate nonprofit organizations that any discussion, analysis and proposed solutions to deal with documented abuses under the present laws will hurt "innocent" nonprofits. To limit the possibility of misunderstanding and unintended injury, ACIL wants to define its terms of reference.

First, let us provide a context. In the last twenty-five years, the American economy has been transformed into a services and information economy. Over 70 percent of the jobs are in services and the numbers of highly technical and skilled jobs are growing dynamically . As we have moved away from the labor-intensive agriculture and manufacturing sectors to growth in jobs in services, nonprofits predominantly engaged in providing commercial services, have increasingly been competing directly with for-profit businesses. One result of the changing economy has been a rapid growth in the nonprofit sector (roughly 14 percent of the jobs in 1984 were in this dynamically growing service producing sector, according to Independent Sector).

This rapid growth has been accompanied by a dramatic change in the nature and character of tax-exempt organizations. Henry Hansmann of Yale University's Program on Non-Profit Organizations describes what has happened:

> Fifty years ago the nonprofit sector was heavily populated with organizations, such as traditional charities, that rely heavily on philanthropic donations for their support. Today, in contrast, the bulk of the nonprofit sector is made up

> of "commercial" nonprofits -- that is, nonprofits that provide services to the public almost exclusively on a fee-for-service basis and receive little or no donative financing. 1/

ACIL's concern is with these "commercial" nonprofits, principally those that benefit unfairly from exempt status under certain categories of Section 501(c)(3) of the Internal Revenue Code relating to "scientific" and "testing for the public safety" activities or enjoy blanket exemptions from the unrelated business income tax provisions dealing with "research."

How large is the problem presented by these "commercial" nonprofits operating under the guise of organizations engaged in "scientific" research or "testing for the public safety?" It is huge and growing rapidly. Using the Research Centers Directory (9th Edition 1984-1985) as a source, we know that nearly 7,500 nonprofit research organizations and university institutes are listed in the disciplines of agriculture, business, conservation, education, engineering and technology, environment, government, law, life sciences, mathematics, area studies, physical and earth sciences, social science and humanities and multidisciplinary programs.

Examining only one category where a number of nonprofit organizations competing with technical service companies appear, "multidisciplinary programs," reveals that 240 nonprofit organizations are identified. About 40 of these nonprofit organizations have technical staffs greater than 50. Total sales for this group are approximately $2 billion. Twelve entities in this group of 40 have 70 percent of the revenues ($1.4 billion). By extrapolating from this analysis, we believe that it is accurate and conservative to estimate that revenues generated by nonprofits engaged in commercial research exceed $30 billion. The commercial nonprofit research entities are, of course, only a small part of a much larger universe of commercial nonprofits operating in a broad range of commercial activities.

No similar directory is available for nonprofit organizations who test for the "public safety." A description of one well known tax-exempt organization "testing for the public safety" will provide some sense of the dimensions of the unfair competition in this field of laboratory activity.

Underwriters Laboratories, Inc. ("UL"), is one of the country's leading laboratories. It operates as a not-for-profit tax-exempt organization. In 1984, it reported revenues of $116,733,260. UL operated as a taxpaying business from its inception in 1901 to 1954 when Section 501(c)(3) of the Internal Revenue Code was amended to extend an exemption to organizations "testing for the public safety." There is virtually no legislative history to justify this exemption. Unlike the National Geographic Society which arguably has changed and transformed itself from a legitimate tax-exempt educational organization to a business, UL began as a business, continued as a business, but at a critical time changed to tax-exempt status to more effectively pursue its business goals.

1/ Hansmann, "The Effect of Tax Exemption and Other Factors on Competition Between Nonprofit and For-Profit Enterprise," 1 Yale University (July 1985).

The Federal Trade Commission in a rulemaking proceeding initiated in 1978 developed extensive evidence on the domination of the product certification field by a few well-established and nationally known nonprofit certifiers like UL and Factory Mutual Engineering Corporation. While there are numerous private sector organizations that are qualified to provide certification services, they have consistently been at a major disadvantage in competing. When local codes and government regulations require laboratory approval, reference is often made either to a "nationally recognized testing laboratory" or a particular nonprofit laboratory by name. In the minds of many government officials, a few nonprofit laboratories have become synonymous with the term "nationally recognized laboratory." In short, the deficiencies in the present tax laws governing commercial nonprofits in the laboratory field are part of a far more pervasive pattern of unfair advantages accruing to nonprofit commercial laboratories under present laws, practices and policies. These unfair advantages have serious consequences in terms of reduced competition, inefficiencies, barriers to innovation, misallocation of scarce resources and the loss of badly needed tax revenues.

The Subcommittee in its examination of present laws must distinguish between traditional charitable, religious and educational organizations and commercial nonprofit organizations that have benefited from the deficiencies and loopholes in the unrelated business income tax provisions and from the unstructured growth of the exemption provisions, often without explanation or justification.

The exempt sector of the economy is large and growing dramatically. At the end of 1985, the IRS Exempt Organization Master File contained over 841,000 individual exempt entities. This number included 349,000 Section 501(c)(3) organizations. Over the last decade, the number of exempt organizations has increased by 150,000 and over 71 percent of this growth is 501(c)(3) organizations. With growth has come the commercialization of the sector. The General Accounting Office, in a report issued in February 1987 on "Competition Between Taxable Businesses and Tax-Exempt Organizations" (GAO/B-217690), stated that 501(c)(3) organizations were relying less and less on contributions, government grants and dues and more and more on income-producing or commercial activities. As a percentage of total revenue, contributions declined from 36 percent in 1946, to 27 percent in 1975 to 18 percent in 1982.

Whether reduced federal funding, the changed character of the economy or other factors account for the trend is not relevant. What confronts this Subcommittee and federal policy makers is the fact that more and more commercial activity is occurring in a nonprofit setting. While the facts available to us do not begin to document the full extent of this phenomenon, they establish that a dramatic transformation in what nonprofits do has already occurred and is growing at an alarming rate.

II. ADEQUACY OF PRESENT LAWS

Nonprofit corporations are, in fact, non-stock corporations, but "nonprofit" fails to reflect their income accurately. All of the nonprofits with which ACIL is concerned earn a "profit," but have certain limitations attached to its use. As Hansmann points out:

> The defining characteristic of a nonprofit organization is that it is barred

> from distributing profits, or net earnings, to individuals who exercise control over it, such as its directors, officers, or members. This does not mean that a nonprofit organization is prohibited from earning a profit. Rather it is only the distribution of a profit that is prohibited; net income, if any, must be retained and devoted to the purposes for which the organization was formed. (Emphasis added). 2/

A more apt description of the nonprofit sector might be "nondistribution" sector.

Acknowledging that some recognition of the tax consequences of income-producing activities of nonprofits was needed, a tax on "unrelated business income" was imposed in the Revenue Act of 1950. The reason for the enactment was to "eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations on the same tax basis as the non-exempt business endeavors with which they compete."

Unfortunately, tax paying independent laboratories experience unfair competition from commercial activities of nonprofit organizations in two categories: (1) sales of laboratory research, analytical and testing services, which are the heart of the exempt purpose of a large number of tax-exempt organizations; and (2) the same commercial laboratory services broadly interpreted as incidental to an organization's exempt purposes.

Many organizations engaged in scientific research or testing for the public safety are in the first category. There is no question that their business activities are "substantially related" so long as the purposes for which such organizations are organized qualify as tax exempt purposes under 501(c). Unrelated business income is not triggered.

Incidental commercial activities of tax exempt organizations raise interpretative questions, but special exemptions in the unrelated business income provisions for the most part provide blanket protection to the nonprofit organizations operating in competition with private laboratories. Excluded from the unrelated business income tax is income derived from (1) research for federal, state or local governments; (2) research for any person by a college, university or hospital; and (3) research for any person by an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the general public.

The reason for the first exemption, which appeared in the 1950 Act, was that "most of this work is done on a cost basis" and "it is not believed that such work is ordinarily undertaken on a profitmaking basis." No reasons were stated in 1950 for the second and third exemptions.

These exemptions have long since lost their validity, if indeed they were ever justified.

2/ Hansmann, "Reforming Non-Profit Corporation Law," 129 U. Pa. L. Rev. 197 (1981).

A. SCIENTIFIC

The inability to define precisely and limit the scope of "scientific" as a basis for tax exempt status requires serious attention by this Subcommittee. Basically, a "scientific" organization is one engaged in scientific research or otherwise operated for the dissemination of scientific knowledge. A requirement underlying this exemption is that an organization must serve a public rather than a private interest. This area of tax exempt law focuses principally on the concept of "research." The term "scientific" includes the carrying on of scientific research in the public interest.

The determination as to whether research is scientific does not depend on whether the research is "fundamental" or "basic" as contrasted with "applied" or "practical." However, federal tax law excludes from unrelated business taxable income all income derived from fundamental research the results of which are freely available to the general public, all research by a nonprofit for a governmental entity and all research by a university for anyone. Under present law, such research, even if incident to commercial or industrial operations is not taxable.

The existing law presents a double competitive hit for independent taxpaying laboratories. Many organizations are granted tax exempt status as "scientific" organizations, even though their principal mission is not fundamental research, but applied commercial research in direct competition with taxpaying organizations. Presently, these commercial research activities will be viewed as "substantially related" and not subject to the unrelated business income tax. The broad "research" exemptions from unrelated business income simply assure that there are no taxable consequences even if an activity is incident to a commercial operation. In short, the present law contains huge loopholes which create unfair competition.

Several case histories are attached to this testimony to illustrate the inadequacies of the present law (Tabs 3-6).

B. TESTING FOR THE PUBLIC SAFETY

Section 501(c)(3) of the Code specifically recognizes "testing for the public safety" as an exempt activity. Thus, income derived from such activity cannot be considered unrelated business income. Present law has not been implemented to examine carefully whether a project constitutes the testing of consumer products to determine the products' safety for the general public as distinguished from the safety testing of consumer products for the benefit of the manufacturer or industry. While the interpretative and enforcement issues are serious, the basic question to consider is why this exemption is in the law in the first place. Severe dislocations in the economy have developed as a result of this exemption. A special case study (Tab 3) is attached to my testimony which illustrates the consequences of allowing nonprofits in the field of laboratory testing to take advantage of tax exempt status with no oversight, no review of the basic reasons to have this category of exempt organization and no effort to limit the injury to legitimate tax paying businesses.

III. COMPETITIVE ADVANTAGE

The urgency of eliminating abuses from the present law governing organizations engaged in applied research, development and testing is best understood when the full range of competitive advantages nonprofits have is assessed. John Copeland and Gabriel Rudney, who have collaborated with the Yale study of nonprofit organizations, believe that nonprofits have a competitive advantage without reference to tax exemption. These non-tax advantages include

> [A] marketing advantage because the public generally presumes that nonprofit managers have greater incentive to provide good quality service at reasonable prices and ... subsidies in the form of government grants and private donations which can finance their expansion. 3/

Add the substantial advantage enjoyed by nonprofits granted exemption from federal, state and local taxes, particularly where a nonprofit carries on a "related" business activity to earn income, and it is easy to understand why knowledgeable small business leaders ranked the issue of unfair competition as their number three priority among 60 top recommendations at the 1986 White House Conference on Small Business. Various commentators who have studied nonprofits cite the competitive advantages flowing from the present provisions of the Internal Revenue Code:

- In direct competition with for-profits, nonprofits can offer their services at lower prices, since they pay no taxes.
- Nonprofits enjoy easy market entry in areas already served by tax-paying small businesses, thus disrupting the market potential for tax paying businesses serving the same market.
- Nontaxed retained earnings are used for expansion through the acquisition of advanced equipment, and to outbid for-profits in obtaining key personnel.

An analysis of key financial indicators of the commercial nonprofits which are described in the attached case histories, as contrasted to a typical for-profit laboratory, shows graphically the financial benefits of operating as a tax-exempt entity. It is interesting to note that the salaries of these nonprofit organizations, as a percentage of total revenues, are significantly higher than the for-profit laboratory. (Tab 7).

Using the Form 990s as a source of information, a detailed analysis has been prepared by Bruce Bullock, a tax executive with the accounting firm of Ernst & Whinney, of the corporate income tax effects on two well known commercial nonprofits, Underwriters Laboratories and the National Sanitation Foundation Testing Laboratory, were they to be

---

3/ Copeland and Rudney, "Business Income of Nonprofits and Competitive Advantage," Tax Notes 748 (Nov. 24, 1986).

subject to a corporate income tax obligation under Subtitle A of the Internal Revenue Code (Tab 8). 4/

Based on this analysis, Underwriters Laboratories would be subject to at least $5,607,527 of income tax expense on income of at least $12,190,275 and National Sanitation would recognize $88,764 of income tax expense on income of $236,988. The income tax expense was computed using 1984 tax rates.

IV. RECOMMENDATIONS

Testimony presented at this hearing and at other forums establish conclusively the dynamic evolution and growth of the tax exempt community and the increasing competition between commercial nonprofits and tax paying small businesses. In spite of a widespread national debate on this phenomenon, the Federal government has done shockingly little to collect and disseminate statistical information and data in a systematic way. It is startling to find that non-government sources have been required to fund research to develop, improve and make available comprehensive data about the nonprofit sector. For example, Independent Sector is currently providing partial financial support to the Statistics of Income Division of the Internal Revenue Service to assure the continuation of its collection of two national samples of private foundations and tax exempt organizations. In the meantime, the Internal Revenue Service has yet to computerize the data which is submitted annually by non-profit organizations on the Form 990. The present IRS methodology to collect data does not identify the type, specific nature, or extent of income producing or commercial activities of tax exempt organizations.

The General Accounting Office in its February 1987 report provided graphic examples of the deficiencies in IRS' data collection:

- IRS reported about 870,000 active tax exempt organizations but the Independent Sector estimated that there were almost 1.2 million nonprofit organizations.
- IRS officials recognize that the primary exempt activity codes reported by organizations at the time of their exemption may not now be accurate and that others may have been erroneously recorded. Further, IRS has been unable to determine the status of over 50,000

4/ The income and deductions for Underwriters Laboratories and National Sanitation Foundation Testing Laboratory were obtained from their 1984 and 1985 Form 990 tax returns, respectively. To compute taxable income it was assumed that all dividend income was earned on investments in domestic corporations which are subject to the dividends received deduction provided by IRC Section 246. The dividends received deduction would give Underwriters Laboratories a $4,536,199 reduction in taxable income and would give National Sanitation a $87,515 decrease in taxable income. If these dividends were from other than domestic corporations, taxable income would not be so reduced and tax would be higher to the extent of 46 percent of the herein calculated deduction.

organizations with which it has had no contact for several years. Also IRS officials stated that some of the revenue and asset data it maintains are flawed.

- Income producing or commercial activities cannot always be specifically identified because revenue from such activities reported to IRS by tax exempt organizations may not be sufficiently detailed and IRS totals income items in its data base.

We join with representatives of the nonprofit sector in urging Congress to take a series of actions to assure that the federal statistical collections on nonprofit organizations are improved as soon as possible. Current federal government data sources could be extremely useful in contributing to an information base on the nonprofit sector if some simple revisions were made. Independent Sector has recommended three major sources of government information where such revisions are possible: (1) data generated from population or household surveys; (2) data derived from canvasing economic establishments; and (3) data compiled from administrative records.

It is our belief that these and other measures should be undertaken to improve the quality and adequacy of federal data on the nonprofit sector.

The need for better and more data, however, should not delay action to revise and strengthen present laws, regulations and policies governing commercial nonprofits. The Oversight Subcommittee should recommend that the present exemption for organizations "testing for the public safety" be eliminated. Further the need to clearly define the scope of the exemption for "scientific" organizations is apparent. Also blanket exemptions from the unrelated business income tax provisions covering research for government, university research for any person, and fundamental research which is performed for proprietary reasons should also be eliminated. Finally the numerous examples of abuses under the present laws make clear that IRS must assume greater responsibility for determining when an organization qualifies for tax exempt status and when its commercial work should, in any event, be subject to tax under an appropriate test. In the case of nonprofit organizations like the National Geographic Society, which have been transformed into highly successful businesses, IRS should be quick to determine that they no longer function in a way that is consistent with their original tax exempt purposes and remove their tax exempt status.

Ultimately the integrity of the system to qualify traditional charitable, religious, educational and scientific organizations as tax-exempt can only be maintained if IRS begins to make clear distinctions between commercial nonprofits and donative nonprofits, clarifies existing law to discourage commercial activities in a nonprofit setting, and enforces the law in a uniform and fair way. In the absence of a strong initiative to clean up the mess that has developed over 80 years or longer, the problem of competition between the nonprofit and small business communities will continue to grow. Leaders from both sectors very much want to pursue cooperative activities which serve their communities. But only if a genuinely level playing field is created will distrust be eliminated from this important relationship.

NOTE

Tab 1, a detailed breakdown of specific services covered within technical testing disciplines, is available upon request.

Tab 2 is an article on the National Geographic Society which appeared in the Washington Post March 8, 1987.

Tab 3

CASE HISTORY ONE

UNDERWRITERS LABORATORIES, INC.

Within the testing field, there are major examples of abuse of tax-exempt status. One such example is Underwriters Laboratories, Inc. ("UL") which qualifies for tax exemption under the "testing for public safety" provision of Section 501(c)(3) of the IRS Code. UL operated as a profitable business until the "testing for the public safety" language was added to the Code in 1954. Today UL is a sophisticated, aggressive, rapidly growing $150 million a year business that differs from its for-profit competitors only in that it pays no taxes and enjoys the other benefits of nonprofit status. Beyond that it is, among other things, a dominant monopoly in the electrical safety certification market. UL uses its monopoly position and tax-exempt status to move aggressively into other markets both domestic and foreign. It represents a serious threat to the development of and in some cases even the continued existence of a number of small testing firms.

UL is a perfect example of a big business enjoying "brand name' recognition. With its best known activities being in testing and certification of electrical and mechanical products, it has a mythical halo of doing good for the public. It is almost quasi-public in that many products in large measure cannot be sold or installed across the country unless the UL label or listing is present. Governmental code and inspection bodies by and large require such UL labeling and listing. These requirements give UL a status in the electrical safety certification market that is almost exclusionary to other, tax paying, testing businesses equally qualified to perform these services and who offer manufacturers a much needed alternative to UL.

The evolution of UL from a taxpaying business to a tax-exempt nonprofit business illustrates the deficiencies in the present law.

In 1901, an Illinois corporation known as Underwriters Laboratories was formed by the National Board of Fire Underwriters to conduct research and investigations concerning insurance hazards and risks. In 1936 a Delaware corporation was organized which acquired the assets and liabilities of the Illinois company. The company by that time was in the business, among other things, of furnishing engineering, testing and inspection services in connection with electrical and mechanical products.

In 1943, the Seventh Circuit Court of Appeals affirmed a decision of the Board of Tax Appeals denying tax-exempt status to UL. 1/ The court's findings and conclusions are still valid today. The question was whether UL qualified for exemption because it was organized and operated exclusively for charitable, educational or scientific purposes within the provisions of Section 101(6) of the then Revenue

---

1/ Underwriters Laboratories v. Commissioner of Internal Revenue, 135 F.2d 371 (7th Cir. 1943), cert. denied, 320 U.S. 756 (1943).

Act. An additional issue was whether UL was exempt as a business league under Section 101(7) of the Act.

The court took notice of UL's ample fees and large profits:

> An ample fee is charged for the testing service, and the obligation to pay this fee does not depend upon the product passing the test. It is from these fees that petitioner's income is almost entirely derived. The petitioner's trustees have the power to assess dues against its members, but this has never been necessary because of the large profits it makes. The petitioner made refunds ... to its manufacturers who used its label services .... An individual purchaser of a piece of merchandise cannot get a test under any circumstances. In other words, the testing service is for the manufacturers who pay the ample fees that give the petitioner its large profits. As the Board observed: 'Undoubtedly, it could have established prices which would not have resulted in such substantial profits. Not having done so, it is reasonable to assume that it intended to operate for profit.'

135 F.2d at 373.

The court rejected UL's claim that the public interest language in its articles of incorporation entitled it to charitable status:

> It was not the public interest that prompted the establishment of the petitioner. It was financial gain and business advantage. The primary concern of the petitioner was that of its membership ... and the manufacturers who paid its ample fees. Whatever benefit inured to the public was only incidental to the primary concern. Whatever benefit the public received was not as a 'gift for public use' ... but was to enable some one to sell something to the public by giving to the public something better than it otherwise would have received. That may be good business but it is not charity.

135 F.2d at 373 (quoting Kain v. Gibboney 101 U.S. 362).

The court rejected UL's claim to exemption as a scientific institution, educational organization and as a business league by stating:

> It [UL] did not operate on the basis of science for the sake of science. It was science for the sake of business. The fact that scientific methods were used does not alter the case. Most businesses today use some kind of scientific processes or methods.

> ....
>
> It could hardly be claimed that this petitioner was organized and that it existed to educate the public. Education is not its business, except as an incident to its main purpose to serve its members and give return to the manufacturers that use its service.
>
> ....
>
> We know judicially that many business concerns conduct commercial testing laboratories for profit. The business which [UL] was engaged was a commercial testing laboratory, and of a kind usually conducted for profit, and is not exempt.

135 F.2d at 373-74.

In spite of UL's growing reputation and success in the commercial testing, inspection and certification business, Congress abruptly changed the rules of the game in 1954 by adopting "testing for the public safety" as a basis for tax-exempt status. There is virtually no legislative history justifying this new category of exempt organizations. The conference report on the 1954 legislation notes that this amendment (Amendment No. 102) was offered by the Senate Finance Committee to extend the exemption to organizations which test for public safety if they "meet the same requirements imposed on tax-exempt scientific, educational, etc. organizations," and was acquiesced in by the House conferees. H.R. Rep. No. 2543, 83rd Cong., 2d Sess. ____ (1954), reprinted in [1954] U.S. Code Cong. and Ad. News 5280, 5306. The Senate Report states that this language "is intended to govern organizations which test consumer products, such as electrical products, to determine their acceptability for use by the general public." S. Rep. No. 1622, 83rd Cong., 2d Sess. 310 (1954), reprinted in [1954] U.S. Code Cong. and Ad. News 4621, 4950. No discussion of the amendment occurs anywhere in the record of hearings and debates on the bill.

The sole clue to the origin of the amendment under which UL is now tax exempt, is a brief letter from Underwriters Laboratories included in the record of the hearings before the Senate Finance Committee. The letter notes that since the 1943 Court decision, UL has paid income tax on any earnings "set aside for the purchase of new or improved test facilities" and, further, that tax exemption was lost in the various states where it operated. UL requested an amendment to Section 501(c)(3) of the Code by inserting the words "testing for public safety" to enable it to "expand its testing facilities out of earnings."

Once UL was successful in converting from a taxpaying business to a tax-exempt business, its expansion has accelerated, including a range of non-safety business activities. For example, for twelve years, private laboratories have been attempting to participate in the $70 million testing of products requiring compliance to Occupational Health and Safety Act ("OSHA") standards. OSHA recognizes only two laboratories to do this work, UL and Factory Mutual, thereby creating a monopoly. Law suits, hearings and complaints by other laboratories have to date failed to break that barrier. UL's dominance, in what is in effect a product or material evaluation with safety a secondary benefit, is presently "locked" into OSHA work.

Other examples of UL's regular non-safety activities or activities only incidentally related to safety demonstrate further the unfair business advantages flowing from UL's nonprofit status.

In its brochure, "The Fact-Finding Investigation," UL describes services available to the manufacturer "as a means of evaluating innovations in Building Construction."

The brochure explains that when a new product or design is submitted, it is

> considered in all its aspects including its intended use, production, code involvement, installation methods, and inspection procedures. From this UL engineering evaluation study, a test program is developed including comparative tests with recognized products and techniques. After review with the submitter the tests are performed and the results, with no conclusions drawn or recommendations made are provided to the submitter for his submission to building code groups and other agencies charged with the responsibility for approving public safety aspects of building construction, or for comparing the innovation with currently recognized products or techniques.
>
> ....
>
> When the development has received code recognition, Underwriters Laboratories is then in a position to create new Safety Standards, tests, identify components and similar designs.

The brochure explains under "Who can apply" that, "usually the manufacturer makes the submittal because of his desire to obtain prompt recognition of a new product. Many submittals have been made by trade associations because the industry wants to use a new development." Finally, under a "partial list" of developments that have "benefited" by this UL program is "Plastic Conduits and Fittings."

This brochure and the UL services offered demonstrate the relationship that exists among UL and its manufacturer and industry association customers. UL's "testing for public safety" in the case of new products, designs and techniques for building construction, is performed for a manufacturer or industry association to influence the acceptance by public building code bodies and officials. The engineering evaluation and resultant test program is developed with the submitter's involvement but without representation of the public officials that it is intended to influence. The UL submitter-developed test program includes "comparative tests with recognized products and techniques" without representation by this group and without any other public, user or consumer representation.

It is also significant that the UL submitter-developed test program for an innovation is described by UL as considering "all aspects including intended use." This refers to the inclusion of not only the safety aspects of a product or design, but also its non-safety installation and performance aspects, and the comparative testing of the non-safety aspects of competitive products. A "Fact-Finding Investigation" by UL will result in data that will support manufacturer or industry association marketing by overcoming any safety restrictions on marketing; and will become a marketing tool for the manufacturer or trade association with non-safety related, comparative information.

It is, therefore, apparent that UL is using its status as a nonprofit organization to provide non-safety related product testing, comparative testing, and other services in support of manufacturer and trade association marketing. UL's role with the manufacturer or trade association in product marketing seems wholly inconsistent with nonprofit status.

To further demonstrate UL's relationship with manufacturers and trade associations as a product marketing resource, the UL brochure identifies "Plastic Conduits and Fittings" as products that have benefited by a UL "Fact-Finding Report", which accomplished code recognition and placed UL in the position to write its Standard for Safety No. 651. However, the use of plastics on wire, cable, and electrical conduit had become the center of controversy concerning the potential toxicity of the products of combustion in the fire environment.

Over the years as public concern about combustion toxicity increased, UL supported the position of its marketing client manufacturers and their trade associations. That position was first, that there was insufficient evidence that plastics were a major contributor of toxic fumes; and later there there was no single protocol for toxicity testing that would provide accurate data. UL, therefore, never added the hazard of toxicity to its safety standard.

On December 16, 1986, New York State mandated toxicity testing be conducted on wire, cable, and electrical conduit and the results of such data filed by December 16, 1987. The New York requirement is for data on which at some subsequent time, some further requirements may be promulgated. It is not a safety standard and sets no result restrictions. UL has still not included such testing in its standards. However, since the manufacturers and their trade associations will need to file this "information" to continue to market plastic conduits and fittings in New York State, UL has issued a press release, under the title "An Independent, Not For Profit, Organization Testing for Public Safety" advising that "UL CONDUCTS COMBUSTION TOXICITY TESTS."

The reasonable conclusion, since UL has not provided such testing in the past for "public safety," is that it is now providing it to continue to support the marketing of plastic conduit and fittings. While there is nothing intrinsically wrong with the support of product marketing with factual data produced by independent laboratories, it should be a competitive private sector activity. UL's involvement not only takes unfair advantage of its tax favored position in such a competition, but in placing UL in the position of supporting private sector marketing, raises the question of whether the performance of such work can ever be consistent with status as an organization "testing for public safety."

The non-safety related UL marketing assistance relationship that has grown between UL and its safety certification clients increasingly has an international dimension. An idea for an IECQ System (International Electrotechnical Commission Quality Assessment System for Electronic Components) began in Europe in 1966. Its aim was to promote the harmonization of standards and establish test and inspection procedures to facilitate the interchange of products and materials manufactured and distributed within the member countries. The idea was elevated to the international action level by the regional European CENEL Plan, not open to membership from countries outside of this group. In 1970 the Electronics Industries Association ("EIA") was alerted to the regional character of the CENEL Plan and through the U.S. National Committee of the IEC (International Electrotechnical Commission), the IEC was asked to operate a worldwide Quality Assessment System for Electronic Components.

The System developed by IEC is open to all member countries of the IEC which have established domestic organizations to operate within the System Basic Rules and Rules of Procedure, and which agree to recognize the approvals of manufacturers and test laboratories and the qualification approvals of components released in other participating countries. Membership in the plan, in addition to financial obligations, requires the member country to have in existence a National Authorized Institution, a National Standards Organization, a National Supervising Inspectorate and a Calibration Service.

In 1975 the U.S. National Committee of the IEC voted to name itself the National Authorized Institution and formed an Electronic Components Certification Board ("ECCB"). In 1976 the Electronics Industries Association voted to become the National Standards Association for the System and in December 1977, Underwriters Laboratories was selected by the ECCB to be the U.S. National Supervising Inspectorate ("NSI").

From the 1970 alert through its 1977 appointment, and into 1982, when the IECQ System became operative, UL financed its own involvement which included extensive foreign travel. UL's financing and subsequent duties for the program is described, by A.M Wilson, Secretary of the ECCB and a Vice president of EIA, in this way: "I think it's important to understand that the IECQ System is a Quality Assessment System that attempts to assure that the performance [not safety], of an electronic component, [not equipment], complies with a specification approved for use in the System; either an IEC Technical Committee developed specification, or a provisional specification developed by one of the other participating countries."

The performance (not safety) specifications and provisional specifications related duties of the UL as NSI include: manufacturer approval; component qualification; and accreditation of testing facilities capable of demonstrating compliance of the electronic components to the prevailing manufacturer specifications and international standards. The testing facilities accredited by UL include those of the manufacturer and/or independent laboratories that may be used by the manufacturer to demonstrate compliance. Both the non-safety specifications of EIA members, and the test standards which are used for compliance testing were unfamiliar to UL since they are not safety but performance related. It was necessary for UL: to hire additional personnel and consultants; to accredit the General Electric Co. as an independent testing laboratory; and to invest in the purchase of testing instrumentation and equipment in order to perform its work as the NSI.

To summarize we find UL now in a non-safety component program, approving manufacturer quality systems, accrediting client and independent laboratories to perform testing to non-safety performance specifications intended to assist (many of the same manufacturers that carry UL domestic safety labeling) in international marketing. Additionally the same system as developed for international marketing has now been developed by UL/EIA as voluntary product certification programs, being offered to the Department of Defense and General Services Administration to replace components on DoD and GSA Qualified Products Lists. The total investment in both time (since 1970) and funding that has been made by UL to establish itself in an international non-safety related marketing scheme has in large measure been made possible by the earnings UL has retained as a consequence of not paying taxes since 1954.

CASE HISTORY TWO

University of Iowa Hygienic Laboratory

Over a period of years, the University of Iowa has established a substantial commercial laboratory capability in the environmental testing field. Known as the University of Iowa Hygienic Laboratory, not only have private laboratories in the region experienced direct competition from this university source, but the Iowa laboratory has become a national competitor.

The charter for the Hygienic Laboratory reads as follows:

> The state hygienic laboratory shall be a permanent part of the state University of Iowa. It shall make or cause to be made microbiological and chemical examinations and other necessary investigations by both laboratory and field work in the determination of the causes of disease, shall suggest methods of overcoming and preventing the recurrence of the disease, and shall evaluate environmental affects and scientific needs, whenever requested to do so by any state agency, state institution, or local board of health when the investigation or evaluation is necessary in the interest of environmental quality and public health and for the purpose of preventing epidemics of disease.

The University also has a policy which allegedly governs the operations of the Hygienic Laboratory:

> It is the policy of the University Hygienic Laboratory to provide services of a specialized technical nature to entities outside of the State of Iowa only when, in the judgment of the prospective purchaser of such services, the University Hygienic Laboratory is uniquely qualified to provide such services.

Contrary to its charter and expressed policy, the University of Iowa Hygienic Laboratory provides a wide range of commercial testing services in competition with private commercial laboratories both inside and outside the state of Iowa. These private laboratories are well-qualified to provide the services which Iowa is offering.

Some examples of clients of the University include:

U.S. Environmental Protection Agency
U.S. Corps of Engineers
International Paper Products
Northern States Power
Ottertail Power
Kansas Power & Light
Missouri Department of Natural Resources
E. A. Hickok & Associates
Wenck & Associates
Bruce A. Liesch & Associates
Geotechnology
FMC Corporation

In light of the fact that the University of Iowa Hygienic Laboratory does not pay federal or state corporate income taxes, sales taxes, property taxes, and the like, it is in a position in many cases to price its services at significantly lower levels than necessarily must be charged by taxpaying organizations. As an example of the ability of Iowa to price its services at unusually low levels, attached is an analysis of work performed for EPA under its contract laboratory program for Superfund analytical work (Attachment 1). Why taxpayers should subsidize nonprofit organizations to do routine analytical work of this kind is difficult to understand.

A recent advertisement by Iowa seeking to recruit individuals to provide industrial hygiene positions further dramatizes the problem. The ad notes that "several industrial hygiene and support positions are now available at the University of Iowa to initiate a campus-based, fee-for-service occupational health program targeting small to medium Iowa industries." (Attachment 2)

The University of Iowa Hygienic Laboratory also serves as a regulatory arm of the state in that it accredits other labs that do testing work in the private sector for purposes of compliance with the Safe Drinking Water Act. It is apparent that the position the University laboratory has in accrediting its competition represents a clear conflict of interest with its commercial work in direct competition with the same companies.

The Iowa case is one of many examples involving university laboratories that use their tax-favored position to perform routine testing and analytical laboratory work in direct competition with the tax paying sector. The competition is formidable in terms of setting fees, recruiting available talent, certifying its competitors technical adequacy and marketing with the benefit of the nonprofit mystique.

Tab 4
Attachment 7-1

IFB WA 85-J005 OPEN MARKET 01/22/85
SORTED ON BID PRICE

LAB NME	O/N	LOT#	BNA/EXT	PST/EXT	VOA	BNA	PST	ANL	BID PRICE	FULL SMP
/ OF IOWA	N	1							729,000	$729.00
TON ENV CONS	N	1							765,000	$765.00
	O	1							800,000	$800.00
[illegible]	O	1							810,000	$810.00
	O	2							850,000	$850.00
ENG SCI TECH	N	1							887,000	$887.00
TESTING	O	1							895,000	$895.00
TESTING	O	2							895,000	$895.00
TESTING	O	3							895,000	$895.00
TESTING	O	4							895,000	$895.00
TESTING	O	5							895,000	$895.00
TESTING	O	6							895,000	$895.00
TESTING	O	7							895,000	$895.00
TESTING	O	8							895,000	$895.00
TESTING	O	9							895,000	$895.00
TESTING	O	10							895,000	$895.00
TESTING	O	11							895,000	$895.00
TESTING	O	12							895,000	$895.00
TESTING	O	13							895,000	$895.00
TESTING	O	14							895,000	$895.00
TESTING	O	15							895,000	$895.00
TESTING	O	16							895,000	$895.00
TESTING	O	17							895,000	$895.00
TESTING	O	18							895,000	$895.00
TESTING	O	19							895,000	$895.00
TESTING	O	20							895,000	$895.00
L	O	3							900,000	$900.00
G	N	1							990,000	$990.00
UTHERN RES INT	N	1							995,000	$995.00
RSAR	O	1							999,000	$999.00
RSAR	O	2							999,000	$999.00
UTHWEST OK	N	1							1,079,000	$1,079.00
UTHWEST OK	N	2							1,079,000	$1,079.00
UTHWEST OK	N	3							1,079,000	$1,079.00
I	O	1							1,099,970	$1,099.97
UTHERN RES INT	N	2							1,100,000	$1,100.00
AL	O	1							1,274,000	$1,274.00
A ASSOC	N	1							1,348,000	$1,348.00
AL	O	2							1,389,000	$1,389.00
C	O	1							1,810,000	$1,810.00
ERAGE									978,279	$979.29

Tab 4
Attachment 1
73

IFB WA 85-J006 SMALL BUSINESS 01/22/85

LAB NME	O/N	LOT#	BNA/EXT	PST/EXT	VOA	BNA	PST ANL	BID PRICE	FULL C
~~TOXICON~~	~~O~~	~~1~~						899,870	$899.87
P E I ASSOC.	O	1						900,000	$900.00
P E I ASSOC.	O	2						900,000	$900.00
~~P E I ASSOC.~~	~~O~~	~~3~~						900,000	$900.00
P E I ASSOC.	O	4						900,000	$900.00
WCAS	N	1						990,000	$990.00
~~VERSAR~~	~~O~~	~~1~~						999,000	$999.00
VERSAR	O	2						999,000	$999.00
VERSAR	O	3						999,000	$999.00
~~TOXICON~~	~~O~~	~~2~~						999,870	$999.87
NANCO LAB, INC	N	1						1,000,000	$1,000.00
WESTERN RESEARCH	N	1						1,060,000	$1,060.00
~~SW LAB OF OK, INC~~	~~N~~	~~1~~						1,079,000	$1,079.00
SW LAB OF OK, INC	N	2						1,079,000	$1,079.00
SW LAB OF OK, INC	N	3						1,079,000	$1,079.00
~~TOXICON~~	~~O~~	~~3~~						1,099,870	$1,099.87
NANCO LAB, INC	N	2						1,125,000	$1,125.00
NANCO LAB, INC	N	3						1,250,000	$1,250.00
~~RMAL~~	~~O~~	~~1~~						1,274,000	$1,274.00
ENVIRODYNE	O	1						1,340,000	$1,340.00
J & A ASSOC., INC.	N	1						1,348,000	$1,348.00
~~NANCO LAB, INC~~	~~N~~	~~4~~						1,375,000	$1,375.00
RMAL	O	2						1,339,000	$1,389.00
AVERAGE								1,036,287	$1,036.

Tab 4
Attachment 2

INDUSTRIAL HYGIENE POSITIONS

Several industrial hygiene and support positions are now available at the University of Iowa to initiate a campus-based, fee-for-service occupational health program targeting small to medium Iowa industries. This program is initiated under a 3-year Kellogg grant but is expected to be self-sustaining thereafter.

Two IH positions require from 5 to 10 years minimum experience, respectively, and ABIH eligibility; favorable consideration will be given to prior consultation, engineering, safety, and waste and data management experience. A third position of IH technologist is also available. Related positions of agricultural hygienists, physician, and educator are also being created.

Positions include competitive salaries, benefits, and opportunities to direct an innovative service program closely aligned with an active research and education program. Please respond to Prof. W. Popendorf, Division of Occupational and Environmental Health, University of Iowa - AMRF, [ATTN: Recruiting Assistant] Iowa City, Iowa 52242.

The University of Iowa is an
Equal Opportunity Affirmative
Action Employer

Engineer/ Training Instructors

Enviresponse has been awarded the contract to manage the EPA's Environmental Emergency Response Unit. As a result, there are immediate openings for environmental instructors at our Cincinnati, Ohio and Edison, New Jersey locations.

A degree in a related area as well as a minimum of 3 years experience in treatment and disposal of hazardous waste is required for these positions. Duties include training exercises to demonstrate equipment and hands on training under simulated and real conditions for emergency response personnel. Will develop, organize and present other hazardous materials management courses as the need arises.

To be considered, please forward resume including salary requirements to: Supervisor of Recruiting, ENVIRESPONSE, 110 South Orange Avenue, Livingston, New Jersey 07039. An equal opportunity employer.

Enviresponse

SENIOR AND ENTRY LEVEL INDUSTRIAL HYGIENISTS

The Occupational Safety and Health Administration (OSHA) has two openings for industrial hygienists. One is a trainee or entry level position in the Boise Area Office in Boise, Idaho. The other is a senior industrial hygienist position in the Portland Area Office in Portland, Oregon.

This is a rare opportunity for qualified individuals to obtain a full time permanent position offering Career Federal Service Benefits.

Concurrently with this recruiting effort, the U.S. Office of Personnel Management in Seattle, Washington will be accepting applications from qualified persons interested in establishing eligibility for Federal Industrial Hygiene vacancies which may occur in Idaho, Washington and Oregon.

For information on how to apply, call or write: **Patricia Anderson, U.S. Department of Labor, Personnel Management Division, Room 3144, 909 First Avenue, Seattle, WA 98174, (206) 442-4172.**

HAZARDOUS MATERIALS PROGRAM DIRECTOR

GMI Engineering & Management Institute, formerly General Motors Institute, has a position available for an Industrial Hygienist or Industrial Toxicologist with a Ph.D. to direct, coordinate and administer GMI's hazardous materials program for compliance with Federal and State laws. This involves establishing control procedures for hazardous waste collection and disposal and the establishment of an employee training program regarding workplace exposure to hazardous material. Industrial experience is desirable but not essential. Undergraduate degree should be in physics, chemistry or material science. Starting date: July 1, 1987.

GMI is a fully accredited private and non-profit undergraduate college offering degree programs in Mechanical, Electrical and Industrial Engineering and Management Systems. Students attend the Institute on a cooperative basis and are sponsored by over 100 different corporations. Send resume and names of three professional references to:

Ms. Bonnie Pennington, Coordinator
GMI Engineering & Management Institute
1700 West 3rd Avenue
Flint, MI 48502-2276

Application deadline: **April 15, 1987** or until the position is filled.

GMI is an equal opportunity employer.

Tab 5

CASE HISTORY THREE

Syracuse Research Corporation

Syracuse Research Corporation ("SRC") is a not-for-profit multidisciplinary research and development organization which conducts contracts studies in a broad range of applied sciences. Established in 1957, the organization includes the Defense Electronics Engineering Division, a Center for Chemical Hazardous Assessment, Life and Environmental Sciences Laboratories, a Science and Technology Policy Center, a Psycho-Linguistics Center, and an Administrative Support Operation. Research and development, hardware fabrication, and laboratory and field testing are conducted by the Corporation. Consulting services are also available to assist clients in product and process design, performance improvement, cost control and quality assurance.

The Syracuse Research Corporation occupies a modern 66,700 square foot facility located on the south campus of Syracuse University. The Syracuse Research Corporation provides testing and consulting services in direct competition with capable taxpaying firms. By way of example, the attached brochure describes the Syracuse Research Corporation as "full-service environmental testing laboratories" whose mission, capabilities and purpose are virtually identical with its taxpaying competitors (Attachment 1). What is different, however, is the nonprofit corporation's ability to use its revenues not to pay taxes, but to serve as capital for growth. Fee income and net worth have increased accordingly. In its most recent year of operation Syracuse had gross revenues of almost $10 million.

SRC, as a not-for-profit corporation, aggressively markets its tax-favored status as making it possible to "evaluate projects objectively and provide unbiased consulting services to outside industrial and governmental groups." Ultimately, there is no distinction between the work of this nonprofit laboratory and an independent taxpaying laboratory.

FOOD PROTECTION AND ANALYSIS

- FDA Extractables.
- FDA certification for testing of single-service containers.
- Department of Treasury, Bureau of Alcohol, Tobacco, and Firearms; wine testing certification (application to be submitted).
- Bacteriology (including *Listeria* and *Yersinia*).
- Sanitary surveys.
- Nutritional components of foods.
- Food Chemicals Codex Testing.
- Food contaminants, including pesticide/herbicide residues.
- Head space analysis.
- 3-A Sanitary Test.

FULL SERVICE CERTIFIED

TESTING LABORATORIES

A summary of SRC's laboratory capabilities is enclosed. If you wish to inquire about consulting or analysis in addition to that described, please call.

We may be able to help you.

- Tab 5
Attachment I

Syracuse Research Corporation Merrill Lane Syracuse New York 13210
Telephone (315) 425-5100

DRINKING WATER

Certified by NYS DOH for inorganic, organic, and bacteriological analysis.

WASTEWATER

Certified by NYS DOH for inorganic, organic, and bacteriological analysis.

Capabilities include:

- Testing of pretreatment, SPDES and test well samples.
- Identification of unknowns by GC/MS/DS library search.
- Petroleum product matching for hydrocarbon spills.
- Treatability studies.
- Sampling and flow measurement.

SOILS AND SLUDGES

- Organic and inorganic pollutants.
- Cation exchange capacity.

SOLID WASTE

- Hazardous waste classification (EP tox., ignitability, corrosivity, reactivity).
- Certification of wastes destined for land burial in NY State.
- Testing of scavenger oils for use as fuel.
- Delisting petitions.

Accumulating the necessary chemical data for declassification frequently requires method modification or development. SRC will work with your company and the regulatory agencies to ensure data and documentation that are appropriate.

ENVIRONMENTAL FATE STUDIES

Studies include the development of protocol to meet EPA approval. A partial listing of capabilities is given below.

- Partition coefficients.
- Water solubility.
- Vapor pressure.
- Biodegradability.
- Soil adsorption.
- Hydrolysis.
- Photodegradation.

INDUSTRIAL TESTING AND RESEARCH

- Material Safety Data Sheets, including measurement of physical properties.
- Pharmaceuticals.
  - shelf life studies.
  - method development and analysis for pharmacokinetic studies.
  - Head space analysis.
- Oil dispersion testing.
- Radioassay.

Tab 5
Attachment 1

CASE HISTORY FOUR

National Sanitation Foundation

The National Sanitation Foundation ("NSF") is a nonprofit organization established in 1944 for the purpose of providing research, education and research services in the field of health and sanitation. The NSF program was modelled and developed after the standard and certification programs of the Underwriters Laboratories ("UL").

The National Sanitation Foundation Testing Laboratory ("NSFTL") was organized in 1952 as a for-profit subsidiary of NSF to engage in special research projects and to test products to determine if they comply with the appropriate NSF standards. NSFTL issues a seal of approval to complying products. NSFTL also compiles and distributes lists of complying products to public health officials, architects, food service consultants and product purchasers. In 1961, NSFTL converted to a nonprofit corporation and for many years has operated its testing business on a tax exempt basis in direct competition with numerous taxpaying laboratories with similar capabilities. In 1985 NSFTL had gross sales revenues of approximately $5.5 million.

NSF and NSFTL, in providing certification, testing, inspection and research services, occupy a unique position in the environmental and health services business. While one or two of these roles might be legitimately performed in a nonprofit setting, there are serious questions about the interrelationship of these functions in non-taxpaying entities.

Tab 7

COMPARATIVE STATISTICS 1/

	TAXPAYING LABORATORY 2/		TAX-EXEMPT COMMERICAL NONPROFIT LABORATORIES					
			NATIONAL SANITATION FOUNDATION TESTING LABORATORY (1985)		SYRACUSE RESEARCH CORPORATION (1986)		UNDERWRITERS LABORATORIES (1984)	
Sales (lab)	$8.5		$5.2		$9.8		$116.7	
Sales (other)	$0.0		$0.5		$0.0		$ 5.3	
Total Sales	$8.5	0.0%	$5.7	0.0%	$9.8	0.0%	$122.0	0.0%
Officers Salaries	$0.3		$0.2		$0.0		$ 1.1	
Other Salaries	$3.2		$2.3		$5.2		$ 62.7	
Other Personnel	$0.6		$0.5		$1.7		$ 13.0	
Total Personnel	$4.1	48.2%	$3.0	52.6%	$6.9	70.4%	$ 76.8	63.0%
Other Costs	$3.2	37.6%	$2.3	40.4%	$2.4	24.5%	$ 28.5	23.4%
Total Costs	$7.3	85.9%	$5.3	93.0%	$9.3	94.9%	$105.3	86.3%
Total Income	$1.2	14.1%	$0.4	7.0%	$0.5	5.1%	$ 16.7	13.7%
Corporate Taxes	$0.5	5.9%	$0.0	0.0%	$0.0	0.0%	$ 0.0	0.0%
Net Income	$0.7	8.2%	$0.4	7.0%	$0.5	5.1%	$ 16.7	13.7%

1/ Analysis based on most recent information available.

2/ This analysis respresents an estimate of 1987 revenues and a conservative calculation of taxes under the new Tax Act for a typical private independent taxpaying laboratory.

Tab 8

ANALYSIS OF THE EFFECTS OF INCOME TAX ON
TAX EXEMPT ENTITIES
DECEMBER 31, 1984

	UNDERWRITERS LABORATORIES ************	NATIONAL SANITATION ************
GROSS SALES	116,733,260	5,433,015
LESS:RETURNS & ALLOWANCES		
COST OF GOODS SOLD		
GROSS PROFIT	116,733,260	5,433,015
DIVIDENDS (1)	800,506	29,164
INTEREST		
GROSS RENTS		106,914
GROSS ROYALTIES		
CAPITAL GAIN NET INCOME		1,264
NET GAIN OR (LOSS) FROM FORM 4797	(24,527)	(19,278)
OTHER INCOME		32,191
TOTAL INCOME	117,509,239	5,583,270
COMPENSATION OF OFFICERS	1,100,308	215,040
SALARIES AND WAGES	62,705,878	2,324,506
REPAIRS		337,152
BAD DEBT		
RENT	5,402,313	
TAXES	4,251,526	181,386
INTEREST		
CONTRIBUTION		
DEPRECIATION	3,731,331	177,050
LESS DEPRECIATION CLAIMED ON SCHEDULE A		
DEPLETION		
ADVERTISING		
PENSION, PROFIT SHARING, ETC.	4,319,331	
EMPLOYEE BENEFIT PLANS	4,514,265	315,184
OTHER DEDUCTIONS	19,294,012	1,795,964
TOTAL DEDUCTIONS	105,318,964	5,346,282
TAXABLE INCOME BEFORE NOL AND SPECIAL DEDUCT	12,190,275	236,988
LESS: NOL		
TAXABLE INCOME	12,190,275	236,988

Tab 8

COMPUTATION OF TAX

TAXABLE INCOME OVER	NOT OVER	TAX RATE	UNDERWRITERS LABORATORIES	NATIONAL SANITATION
0	$ 25,000	15%	3,750	3,750
25,000	50,000	18%	4,500	4,500
50,000	75,000	30%	7,500	7,500
75,000	100,000	40%	10,000	10,000
100,000	1,000,000	46%	414,000	63,014
1,000,000	....	46% (2)	5,167,777	
			5,607,527	88,764

(1) IT HAS BEEN ASSUMED ALL DIVIDENDS AND INTEREST FROM SECURITIES WAS EARNED ON INVESTMENTS IN DOMESTIC CORPORATIONS. THEREFORE THEY ARE SUBJECT TO THE DIVIDEND RECEIVED DEDUCTION PROVIDED BY I.R.C. SECTION 246

(2) PLUS 5% ON EXCESSOVER $1,000,000, OR $20,250, WHICHEVER IS LESS.

Mr. FLIPPO. Mr. Williams, thank you for your testimony.

Mr. Carlton.

STATEMENT OF DONALD M. CARLTON, MEMBER, BOARD OF DIRECTORS, PROFESSIONAL SERVICES COUNCIL; PRESIDENT, RADIAN CORP., AUSTIN, TX

Mr. CARLTON. Thank you, Mr. Chairman, Congressman Thomas.

My name is Don Carlton, and I am appearing on behalf of the Professional Services Council. I am president of Radian Corp. of Austin, Tex., a professional and technical services firm, employing 1,300 people, specializing in environment, health, safety, materials, and equipment reliability.

Radian is part of a large and rapidly growing segment of the private sector, the so-called services economy. It is estimated that the professional and technical services industry in the United States represents over 270,000 firms generating over $200 billion in revenue and employing approximately 3 million people. A significant portion of this work is in the field of research, development, test and evaluation. This is Radian Corp.'s business and, unfortunately also is the business of 39 nonprofit, federally funded research and development centers, otherwise known as FFRDCs.

There is a list of these FFRDCs appended to my testimony, copies of which you have I believe.

The National Science Foundation estimates that the Federal Government will spend $60 billion on research and development in 1987, and that these nonprofit research organizations which are captives of the Federal Government will do approximately $5.3 billion of this total. This $5.3 billion represents commercial services which can be obtained from private sector, taxpaying organization such as Radian, and hundreds of other private sector firms.

In short, a large percentage of private sector, commercial R&D is performed by captive nonprofit entities created by the Federal Government which do not pay taxes.

The fact that FFRDCs pay no taxes is a significant economic advantage. Retained earnings are used by captive nonprofits to support growth in new applications of technology, compete for highly skilled personnel, and acquire modern facilities and equipment.

The tax advantage is one of the many advantages nonprofit FFRDCs enjoy which have been ably summarized by other witnesses before this subcommittee.

I would only point out one unique nontax advantage which gives FFRDCs an overwhelming position in the Federal R&D business. FFRDCs have a special exemption from competition under the recently enacted Competition in Contracting Act, CICA. As you know, CICA was intended to increase competition in Government contracting and to impose more stringent restrictions on the award of noncompetitive or sole-source contracts. Unfortunately, the statute provides that if an agency head determines that "it would be in the interest of national defense in establishing an essential engineering research or development capability to be provided by an educational or other nonprofit institution or a federally funded contract research and development center." It may award a contract noncompetitively.

The fact is that these laboratories set up for specific national security purposes immediately after World War II have ranged far beyond that initial intent.

One FFRDC set up as a nuclear weapons engineering organization conducts research coal gasification. Very recently, I received a letter from a member of the staff at another FFRDC informing me that his laboratory "can now perform proprietary research on a contract agreement basis and also can license prior patent applications by obtaining patents for industry."

Yet, another example of the unfair competition was a recent award by the Department of Health and Human Services of a sole-source contract to the MITRE Corp., an FFRDC established to support the Department of the Air Force. And I might just digress for a moment to point out that some of the other FFRDCs include Los Alamos, Sandia National Laboratory, Brookhaven, Argonne, et cetera.

HHS asked MITRE to provide technical and toxicological support services to the FDA by gathering, screening, validating and reporting on toxicology data, work that is routinely performed by taxpaying private sector firms whose services could be acquired on a competitive basis. The announcement of the award implied that the MITRE Corp. is the only source which has the knowledge and expertise to conduct the required effort which is simply not true.

There is also nothing unique about the institutional characteristics of MITRE to perform this type of work.

Mr. Chairman, we have many other examples which we would be delighted to supply to the subcommittee if you wish.

To explore this issue further, I suggest an examination of the question, what is the objective of federally funded research? I would argue that the objective is to meet the needs of our society which cannot and will not be met by the private sector.

If you will grant me that definition, I suggest that the ultimate objective of federally sponsored research and development is to develop technology and to transfer it into the private sector where the needs of our country ultimately will be met.

While many FFRDCs have outstanding engineers and scientists, I would argue that there is a lack of incentive to transfer technology developed in FFRDCs into the private sector. Conversely, technology developed in a private sector firm is a business opportunity for that firm. Frequently, the private sector firm will add its own resources to the resources of the Government and, most assuredly, will spend its own time and effort to translate the technology developed under Government sponsorship into a business opportunity.

In summary, FFRDCs compete with a broad spectrum of the scientific and technical community. They compete with the universities. They compete with not-for-profit research institutes, and they compete with the private sector.

They should be allowed to compete. They can and do contribute to our society. But if these organizations are to compete directly with other segments of the scientific community, they should do so on an even basis.

Thank you very much.

[The statement of Mr. Carlton follows:]

Testimony of
Donald M. Carlton
On Behalf of the
Professional Services Council

My name is Don Carlton and I am appearing on behalf of the Professional Services Council ("PSC"). I am President of Radian Corporation in Austin, Texas.

PSC represents hundreds of firms that serve the federal government in a wide variety of high technology and other sophisticated professional and technical services. It is our industry that has ideas as its product -- the application of professional, expert and specialized knowledge to assist government and private sector clients in solving operational, technical and management problems. These services can take many different forms -- computer programming applications, research and development, architect and engineering services, laboratory analysis, systems and equipment test and evaluation, special studies and management consulting, to name only a few.

Professional and technical services companies typically have as their work force individuals with advanced educational qualifications and practical experience in complex problem solving. Normally an interdisciplinary group will work together to solve a client's problem with an economy of time and effort and quality results. These companies are predominantly small and highly competitive with no single firm having any significant share of the market for services.

It is estimated that the private professional services and technical services in the United States represent over two hundred seventy thousand (270,000) firms generating over $200 billion in revenue and employing approximately 3 million people. Over the past twelve months, from February 1986 to February 1987, approximately 2.7 million jobs were created, 40 percent of which were in the managerial and professional specialty category, the highest paid category classified by the Labor Department. This large and dynamically growing sector represents one of the real strengths of the U.S. economy.

It is for this reason that PSC welcomes the initiative of the Subcommittee to review the unrelated business income tax and focus on the federal tax treatment of commercial and other income producing activities of organizations that have tax exempt status under Section 501 of the Internal Revenue Code.

In the field of professional services, there is a fundamental need to review the present tax laws, regulations and policies. These laws and policies have failed to reflect the dynamic growth of commercial research activities in the nonprofit setting and the major competitive advantages enjoyed by nonprofit research organizations. To illustrate the nature and scope of the problem, PSC would like to focus on one specific category of nonprofit research organization, the so-called Federally Funded Research and Development Centers ("FFRDCs"). (Also referred to as Federal Contract Research Centers or "FCRCs".)

FEDERALLY FUNDED RESEARCH AND DEVELOPMENT CENTERS

FFRDCs are nonprofit research and development ("R&D") institutions which exclusively or substantially are financed by an agency of the federal government. They operate as private nonprofit corporations, although they are subject to certain personnel and budgetary controls imposed by Congress and/or their sponsoring agency. There are 39 federally sponsored FFRDCs in existence which perform in excess of $5 billion of federal work without competition and free from corporate income taxes. When it is understood that these are only the "captive" (government-sponsored) nonprofit research institutes (as contrasted to the hundreds of private "non-captive," nonprofit research institutes), the special character and scope of the problem under existing tax laws should be apparent.

There are four categories of FFRDCs: research laboratories, R&D laboratories, study and analysis centers, and systems engineering/systems integration centers. While many of these FFRDCs were established after the second World War (from 1948 to 1963), there has been no effort to date to review their special privileged status under federal law. In spite of the tremendous growth during the same period of thousands of capable, private taxpaying firms engaged in the same commercial endeavors, the federal government has continued to promote the use of FFRDCs. The most recent example is the initiative of the Defense Department to establish a new "captive" nonprofit institute, the Strategic Defense Initiative Institute, to support the Strategic Defense Initiative.

Attached as Appendix A is a listing of FFRDCs and their sponsoring agencies during fiscal years 1983 to 1985. Four of these FFRDCs are ranked among the one hundred largest defense contractors.

The unique issues raised by FFRDCs should be put in a broader context than the tax laws. The Office of Federal Procurement Policy ("OFPP") in the Office of Management and Budget has reflected the widespread concerns about the special role and mission of FFRDCs and issued guidelines to govern their operations. Unfortunately, this policy (OFPP Policy Letter 84-1) has proved inadequate in limiting the work performed by FFRDCs to that category of research services that could not be procured from highly capable private taxpaying organizations on a competitive basis. The problem has been greatly aggravated by a special exemption from competition that FFRDCs enjoy under the recently enacted Competition in Contracting Act ("CICA"). As you know, CICA was intended to increase competition in government contracting and to impose more stringent restrictions on the award of noncompetitive or sole source contracts. Unfortunately, the statute provides that if an agency head determines that "it would be in the interests of national defense in establishing an essential engineering, research or development capability to be provided by an educational or other nonprofit institution or a Federally Funded Research and Development Center" it may award a contract noncompetitively. It is the combination of these many other special advantages together with tax advantages that creates an immense policy challenge in terms of assuring that nonprofit organizations engaged in selling commercial services to government and private clients compete on a fair and proper basis.

These policy concerns have been the subject of increasing controversy and analysis. A report dated May 1983 by the White House Science Council, the Federal Laboratory Review Panel Report (known at the time as the Packard Report), found serious deficiencies in the mission, management and focus of the 16 FFRDCs which were the subject of the review. The report noted that preservation of a laboratory is not a mission. The Office of Science and Technology Policy, in its progress report of July 1984 on the implementation of the recommendations of the Packard Report found that much of the work done by FFRDCs could have been done as well, or better, by private industry. More recently, a Congressional Research Service study dated May 30, 1986, assessing DOD's proposal to establish a new Strategic Defense Initiative Institute, pointed out the advantages and disadvantages of the federal government's use of FFRDCs.

FAVORED TAX TREATMENT OF NONPROFIT RESEARCH ORGANIZATIONS

FFRDCs and other nonprofit research organizations are classified as "scientific" organizations eligible for tax exempt status under Section 501(c)(3) of the Internal Revenue Code. As such, these nonprofit research organizations are examples of a growing trend in the nonprofit sector -- that is, firms whose income derives primarily or exclusively from the sale of services (as opposed to nonprofits that receive a substantial portion of their income in the form of donations). PSC's concern is with the "commercial" nonprofits, not the "donative" nonprofits. It is this subclass of commercial 501(c)(3) organizations that requires the Committee's careful scrutiny.

As the economy has been transformed into one requiring more and more highly skilled services, nonprofits with capabilities in the technical and professional services have increasingly engaged in commercial activities. In the 1980s this dynamic trend has become more and more visible. The traditional rules seem increasingly inadequate.

The principal statutory tool to deal with commercial activities by nonprofit entities has been the unrelated business income tax provision. Changes in business and nonprofit practices raise fundamental questions, however, about the adequacy of current law and its interpretation by administrators and courts.

Nonprofit research organizations have competitive advantages over taxpaying firms for two major reasons:

o Certain basic activities which qualify an organization for exemption, such as "scientific" research, are often commercial in nature; and

o A wide range of business activities of nonprofits engaged in research are considered under the present law as being "substantially related to the function that qualifies the organization for exemption" or are specifically excepted from the application of the unrelated business income tax.

A number of specific exemptions from the unrelated business income tax violate the basic intent to tax unrelated business activities. The examples in the research area are particularly extreme. Excluded from tax is income derived from (1) research for federal, state and local governments; (2) research for any person by a college, university or hospital; and (3) research for any person by an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the general public. When these exemptions were enacted in the 1950 Revenue Act, there was relatively little justification advanced for the exemptions. Research for government was rationalized as appropriate since "most of this work is done on a cost basis" and "it is not believed such work is ordinarily undertaken on a profit-making basis." No reasons for the second and third exemptions were provided.

In light of the transformation of the economy and the establishment of an extraordinarily capable and diverse private sector in research services comprised of thousands of taxpaying companies, these exemptions appear to have lost whatever validity they might have enjoyed in the early 1950s. Nonprofit research organizations, such as the FFRDCs, do contract work for the government which includes a substantial fee (profit). Given the size of the nonprofit research sector presently, it is apparent that this subclass of 501(c)(3) activity represents in and of itself a serious threat to the integrity of the present tax laws.

RECOMMENDATIONS

Blanket exemptions to the unrelated business income tax relating to research (Sections 512(b)(7), (8), and (9)) should be repealed. The overriding concern of Congress in 1950 was to deal with "unfair competition" that is, to subject nonprofit organizations to income tax where they competed in producing similar products or services with taxpaying organizations. The Committee reports demonstrate that the exception for organizations engaged in providing fundamental research, research services to the government, or in the case of a university or hospital, research services to anyone, was made not because there was a resistance to extending the policy of unfair competition to cover these particular areas, but on the assumption that there were few if any profit making entities regularly engaged in performing contract or fundamental research. In 1950, this was a relatively accurate assessment of the state of the market.

Today, almost 40 years later, however, the characteristics of the market have been radically altered, with profit making research entities competing vigorously with tax exempt nonprofits and government in-house R&D entities. The simple fact is that the rationale underlying these particular exemptions has disappeared, making Congressional reconsideration timely and appropriate.

Elimination of these exemptions from the unrelated business income provisions of the Internal Revenue Code is only a modest beginning. In our modern services economy it is essential that we reassess the broad exemption from the corporate income tax of nonprofit "scientific" organizations. As broadly construed under applicable regulations, rulings and decisions, this group of exempt organizations represent a dynamic class of commercial nonprofits that differ very little, except in their favored treatment under federal laws, from taxpaying scientific organizations. To the extent that fundamental research should be promoted, then this subcategory of exempt organizations should be narrowly defined to accomplish only legitimate nonprofit goals.

CONCLUSION

Much has been made by nonprofit representatives of the "anecdotal" nature of the evidence suggesting unfair competition exists under the present tax laws. If the information PSC has provided is analyzed and understood, interested parties from all sectors will recognize that segments of what is called the nonprofit sector are, in fact, huge, thriving and profitable.

The numbers of publications and seminars directed toward educating nonprofits in how to run successful businesses are no accident. Recently the Foundation Center, the only national nonprofit clearinghouse for information on foundations and grants, published a new book, "Managing for Profit in the Nonprofit World." It confirms the fact that many nonprofit organizations are in the business of business. It captures the texture of the nonprofit world in these words:

> Not-for-profit organizations are diverse in their aims and character. They vary from enterprises that cannot by the very nature of their mission make money (such as religious or "voluntary" organizations), to organizations that seek to make money, but for a variety of reasons, decide to operate within the limitations of the tax-exempt, not-for-profit form. Some of these latter nonprofit organizations may even become profitable enough to convert to profit-making companies. Hence, the term "nonprofit" actually covers a spectrum of organizations as different from each other as they are from profit-making organizations.
>
> Equally, the working environment of the exempt not-for-profit world is diverse rather than uniform, as nonprofit organizations have their own varied cultures. The nonprofit universe is not simply a neat and tidy world of days filled only with lofty insights, dispassionate analysis, and people moved by high ideals. Pragmatic as well as altruistic motives often explain the behavior of people who work in nonprofit organizations. Powerful, frequently selfish emotions can be at play. You find in the not-for-profit world strong ambitions, powerful needs for personal approval, heightened desires for personal gain, power, and personal vindication. It is, in short, a very human world...no more or less so than the profit-making segment of our economy.
>
> The not-for-profit world is also an intense, highly competitive universe in which marketing, public relations, economics, strategic planning, and other business considerations are as much in vogue as idealism and a sense of social mission. (at 10-11).

The challenge for this Subcommittee is to make distinctions among different kinds of nonprofits and draw lines which assure that there is a level playing field where nonprofits and for-profits directly compete to provide the same professional services. In an advanced services economy it is not sound public policy to allow the "charitable" mantle to be thrown over significant commercial activity.

federally funded research and development centers, fiscal years 1983-85

NOTE: Total Federal obligations for R&D and R&D plant support to each FFRDC in fiscal year 1983 are shown in parentheses. The overall total is $4,875,690,000.

department of defense
office of the secretary of defense

Administered by other nonprofit institutions:

Institute for Defense Analyses (IDA), Arlington, Virginia ($18,084,000)

department of the navy

Administered by universities and colleges:

Center for Naval Analyses (University of Rochester), Arlington, Virginia ($18,451,000)

department of the air force

Administered by universities and colleges:

Lincoln Laboratory (Massachusetts Institute of Technology), Lexington, Massachusetts ($284,950,000)

Administered by other nonprofit institutions:

Aerospace Corporation, El Segundo, California ($241,532,000)

C^3I Division (MITRE Corporation),[3] Bedford, Massachusetts ($190,280,000)

Project Air Force (RAND Corporation),[4] Santa Monica, California ($16,721,000)

department of health and human services
national institutes of health

Administered by industrial firms:

Frederick Cancer Research Center (Litton Bionetics, Inc., Litton Industries), Frederick, Maryland ($33,918,000)

department of energy

Administered by industrial firms:

Bettis Atomic Power Laboratory (Westinghouse Electric Corp.), Pittsburgh, Pennsylvania ($241,143,000)

Energy Technology Engineering Center (Rockwell International Corporation), Santa Susana, California ($37,970,000)

Hanford Engineering Development Laboratory (Westinghouse-Hanford Corp.), Richland, Washington ($135,633,000)

Idaho National Engineering Laboratory (EG&G Idaho, Inc.; Exxon Idaho Co.; Argonne National Laboratory, West; Westinghouse Electric Corp.), Idaho Falls, Idaho ($152,034,000)

Knolls Atomic Power Laboratory (General Electric Company), Schenectady, New York ($223,200,000)

Oak Ridge National Laboratory (Union Carbide Corp.), Oak Ridge, Tennessee ($268,565,000)

---

[3] Only the C^3I Division of the MITRE Corporation is reported as an FFRDC. All other agency support to MITRE is reported under "other nonprofit institutions excluding FFRDC's."

[4] Only the Project Air Force portion of the RAND Corporation is reported as an FFRDC. All other agency support to RAND is reported under "nonprofit institutions excluding FFRDC's."

Sandia National Laboratories (Western Electric Co., Inc.-Sandia Corp.), Albuquerque, New Mexico ($523,789,000)

Savannah River Laboratory (E.I. duPont de Nemours & Co., Inc.), Aiken, South Carolina ($51,369,000)

Administered by universities and colleges:

Ames Laboratory (Iowa State University of Science and Technology), Ames, Iowa ($18,247,000)

Argonne National Laboratory (University of Chicago and Argonne Universities Assn.), Argonne, Illinois ($207,367,000)

Brookhaven National Laboratory (Associated Universities, Inc.), Upton, Long Island, New York ($168,303,000)

E. O. Lawrence Berkeley Laboratory (University of California), Berkeley, California ($126,147,000)

E. O. Lawrence Livermore National Laboratory (University of California), Livermore, California ($603,049,000)

Fermi National Accelerator Laboratory (Universities Research Association, Inc.), Batavia, Illinois ($174,532,000)

Los Alamos National Laboratory (University of California), Los Alamos, New Mexico ($488,012,000)

Oak Ridge Associated Universities, Oak Ridge, Tennessee ($8,830,000)

Princeton Plasma Physics Laboratory (Princeton University), Princeton, New Jersey ($133,531,000)

Stanford Linear Accelerator Center (Stanford University), Stanford, California ($86,952,000)

Administered by other nonprofit institutions:

Pacific Northwest Laboratory (Battelle Memorial Institute), Richland, Washington ($80,089,000)

Solar Energy Research Institute (Midwest Research Institute), Golden, Colorado ($42,473,000)

National Aeronautics and Space Administration

Administered by universities and colleges:

Jet Propulsion Laboratory (California Institute of Technology), Pasadena, California ($226,445,000)

National Science Foundation

Administered by universities and colleges:

Cerro Tololo Inter-American Observatory (Association of Universities for Research in Astronomy, Inc.), La Serena, Chile ($6,460,000)

Kitt Peak National Observatory (Association of Universities for Research in Astronomy, Inc.), Tucson, Arizona ($11,655,000)

National Astronomy and Ionosphere Center (Cornell University), Arecibo, Puerto Rico ($5,110,000)

National Center for Atmospheric Research (University Corporation for Atmospheric Research), Boulder, Colorado ($32,849,000)

National Radio Astronomy Observatory (Associated Universities, Inc.), Green Bank, West Virginia ($15,900,000)

Sacramento Peak Observatory (Association of Universities for Research in Astronomy, Inc.), Sunspot, New Mexico ($2,100,000)

categories of ffrdc's[5]

Total of Federal obligations, for R&D and R&D plant support to each FFRDC in fiscal year 1983 is shown in parentheses. The overall total is $4,875,690,000

research laboratories ($369,476,000)

DOE: Fermi National Accelerator Laboratory ($174,532,000)
DOE: Stanford Linear Accelerator ($86,952,000)
HHS/NIH: Frederick Cancer Research Center ($33,918,000)
NSF: Cerro Tololo Inter-American Observatory ($6,460,000)
NSF: Kitt Peak National Observatory ($11,655,000)
NSF: National Astronomy and Ionosphere Center ($5,110,000)
NSF: National Center for Atmospheric Research ($32,849,000)
NSF: National Radio Astronomy Observatory ($15,900,000)
NSF: Sacramento Peak Observatory ($2,100,000

r&d laboratories ($4,021,146,000

DOD/AF: Lincoln Laboratory ($284,950,000
DOE: Ames Laboratory ($18,247,000
DOE: Argonne National Laboratory ($207,367,000
DOE: Bettis Atomic Power Laboratory ($241,143,000
DOE: Brookhaven National Laborator ($168,303,000
DOE: E.O. Lawrence Berkeley Laborator ($126,147,000
DOE: E.O. Lawrence Livermore Nationa Laboratory ($603,049,000
DOE: Energy Technology Engineerin Center ($37,970,000
DOE: Hanford Engineering Developmen Laboratory ($135,633,000
DOE: Idaho National Engineering Laboratory ($152,034,000
DOE: Knolls Atomic Power Laborator ($223,200,000
DOE: Los Alamos National Laborator ($488,012,000
DOE: Oak Ridge Associated Universitie ($8,830,000)
DOE: Oak Ridge National Laboratory ($268,565,000)
DOE: Pacific Northwest Laboratory ($80,089,000
DOE: Princeton Plasma Physics Laborator ($133,531,000
DOE: Sandia National Laboratories ($523,789,000
DOE: Savannah River Laboratory ($51,369,000
DOE: Solar Energy Research Institute ($42,473,000)
NASA: Jet Propulsion Laboratory ($226,445,000)

study and analysis centers ($53,256,000)

DOD/AF: Project Air Force ($16,721,000)
DOD/Navy: Center for Naval Analysis ($18,451,000)
DOD/OSD: Institute of Defense Analysis ($18,084,000)

system engineering/system integration centers ($431,812,000

DOD/AF: Aerospace Corporation ($241,532,000
DOD/AF: C^3I Division of MITRE ($190,280,000

---

[5] Categories are defined in the Technical Notes under Performer FFRDC's.

Mr. **Flippo**. Thank you very much, Mr. Carlton. Thank you for your testimony.

Mr. Brong, in your testimony, which was very direct, explicit, you seem to suggest that we eliminate unfair competition by directly taking away the tax exemption from many of these organizations rather than changing the rules on UBIT?

Mr. **Brong**. I have to speak based on the experience I have primarily with one university. So that's my primary reference.

Mr. **Flippo**. Yes.

Mr. **Brong**. We see at that particular university, and again this is confirmed by newspaper reports, and I have citations if the committee wishes. We have a university store, bookstore, if you will, that is the single largest reseller of designer jeans, it sells stereos, refrigerator, cosmetics, et cetera. It also sells textbooks and other essential items relative to the university activity.

We are a rural city. In some cases, it is closer for the students and/or staff and faculty to come to businesses that are not university-related than to go to the university store.

Now, addressing specifically your question. I believe there are definitely activities within higher education that should be tax-exempt, such as the sale of textbooks probably, but not designer blue jeans, not the sale of stereos.

Now, we could argue, I suppose, that toothpaste is essential for health for a student, and designer blue jeans may also be essential.

What I would propose is that there be some agreement as what indeed is essential, what is the basic goal and mission of the instructional program of that institution. And then I would suggest that if the not-for-profit status on these institutions remains that everything that is sold that is not directly related to an essential mission, they would be charged a tax on total revenue, not income. It's too easy to hide suspected profits and so on in the complexity of the institution.

Mr. **Flippo**. Mr. Brong, I believe there was a New York Times article recently that indicated that the State of Washington has or plans to change some of its State law in response to this issue.

Do you know of any changes in State laws that have been made or appear to be enacted?

Mr. **Brong**. You mean other than the State of Washington?

Mr. **Flippo**. Yes.

Mr. **Brong**. The State of Arizona has a law. I don't have specifics in front of me. It is my understanding that the Arizona law is one that is relatively restrictive as far as university sales. Again it was developed, addressing specifically computer sales.

Mr. **Flippo**. Let me ask about any changes in the laws in the State of Washington.

Mr. **Brong**. All right.

Mr. **Flippo**. In property tax or sales tax or any changes of that nature?

Mr. **Brong**. No, there have been none in the State of Washington. We do have a law, Senate bill 5688, which gives until December 1987, for the universities to study and develop a policy statement. This is to be a public and open process.

It was a compromise bill since we had lost for the second year in a row any direct changes in the commercial activities for the institutions.

We do see this as a window, however, to address the problem in the State. But, at this moment, there is nothing that restricts commercial activities.

Mr. FLIPPO. May I ask the rest of our panelists, in trying to and struggling with changing the definition of scientific organization for purposes of qualifying for the tax-exempt status, in your view, how should we change that definition of a scientific organization? Can you have some suggestions for us on how we might change the definition of a scientific organization?

Mr. WILLIAMS. I'm not so sure that the definition needs to be changed. I do think what we're trying to communicate to you in this testimony is that just the word "scientific" itself does not automatically trigger tax exemption.

All of us here are in scientific endeavors, yet all of us here are taxpaying organizations. I think what we are trying to communicate to you is that when there are commercial activities engaged in by tax-exempt organizations, they do two things. They create an unfair situation in competition with taxpaying organizations, give them a mystique that some may or may not deserve because nonprofit carries some connotations of being better. And, in some instances, that may be true; in other instances, it may not.

But I think any tax exempt organization that can show a consistent gain, substantial gain in assets each year, show substantial excess income over expense is suspect as fulfilling the mission that they originally set out to fulfill.

Mr. CARLTON. Mr. Chairman, if I may offer a comment.

One of the biggest concerns that I have about the FFRDCs, if I may target that just for a second, is the fact that they were all set up for a specific purpose and a good purpose. I don't even take issue with that. Nor do I take issue with the dedication of these people to the quality of their work.

What I do take issue with is the fact that that charter has long since been forgotten. And these are good people, and good folks are going to look for other things to do, and they have done a good job of finding other things to do. And it's that direct pipeline to Federal funds which then becomes extremely unfair competition in our view. They can get non-competitive contract awards almost with a telephone call, whereas, we have to go through a stringent competitive process. And it's that definition of the activity—let me call it a mission statement rather than definition of scientific activity which I would draw attention to. And I note in the comments made by the Treasury Department the other day, that the Treasury focuses on whether or not is the information is to be published as a criterion for determining the taxability of the activity?

I would respond the issue is whether the particular organization is doing what it was set up to do, as a possible approach to defining whether or not it is a taxable activity.

May I make one last comment?

I think it's important to note that none of us has said that these organizations ought to go out of existence. What we're saying though is that while we don't run from the competition from FFRDC's. The problem is it's unfair competition.

Mr. **Flippo**. Thank you very much.

Mr. Schulze.

Mr. **Johnson**. Mr. Chairman, if I could just add one short point. This committee is very familiar with some of the most brilliant minds in our Nation coming up with ways to get around particular definitions that you indeed do come up with.

My tax lawyer is the wealthiest guy I know.

It's not that you're looking for a change in definition. It's taking a look at the overall picture here, and that this committee has to develop a mind set, and that mind set is the clear thing that has to happen for us in a taxpaying situation. We just have to have your mind set be the mind set that is really what makes America great, the idea of paying taxes when you make money. It's just that simple.

Thank you, Mr. Chairman.

Mr. **Schulze**. Thank you, Mr. Chairman.

Thank you, gentlemen, for your very interesting testimony. I want to follow up on the line of questioning I began with the previous panel.

Can you tell me about salaries of profit and nonprofit organizations? Do the stereotypes of the professor in the threadbare jacket working for $8,000 a year, sacrificing for the community and the good of mankind, does that hold up today in the testing laboratory in the nonprofit area?

Mr. **Williams**. Well, sir, I would suggest to you that he's not threadbare because of his lack of income. Probably it's his eccentricity that creates that condition.

In our particular area—and by the way, I am from Texas, the chairman's home district—and our university is well paid. They tell a different story to the Legislature and they need more money, and just like you and I, there's a magic about money that you never have quite enough. So I can understand their position.

But being in a competing field, I don't hire any people that are teaching school because I can't afford them.

Mr. **Schulze**. I would guess in a way you're competing almost with the same personnel at times, are you not?

Mr. **Williams**. In a large degree. We may not go quite as high in the degree area, although we hire and use Ph.D.'s. But we probably overall do not have a total high commitment to the Ph.D. level. We've got some awful smart people.

Mr. **Schulze**. Can you give me an idea of starting salaries, what the average scientists in your organization make?

Mr. **Williams**. Right now, a bachelor degree holder would probably start in our firm from somewhere between $2,000 and $2,400 a month. A master's degree would probably add $200 a month to that figure. And the upper and the lower, of course, would be dependent upon how we evaluate their qualifications and ability to contribute their services.

Ph.D. levels may be a salary of $3,200 to $3,500 a month.

Mr. **Schulze**. Any idea what that is in competing nonprofit organizations?

Mr. **Williams**. I would say that if there were a job offer in any one of those categories, he probably would be considering that in relation to an offer from a nonprofit corporation.

Mr. **Schulze**. How about fringe benefits, Mr. Williams? Are there fringe benefits that go with one side or the other which could be——

Mr. **Williams**. I'd say monetary fringe benefits based on my knowledge are reasonably the same. There are other so-called nonmonetary benefits that are created in both sectors, academia or the nonprofit sector, and of course some of us are entrepreneurs by nature and would be totally uncomfortable at any level of compensation in academia or in a nonprofit.

Mr. **Schulze**. Can you offer stock options or other things that they cannot offer, and can they offer housing and some things that you cannot, or don't you get into that kind of specificity?

Mr. **Williams**. We do have stock participation in our firm and it is limited to key employees who have demonstrated an ability to identify with our goals and move forward toward making them.

Mr. **Schulze**. Can you give me some guidelines when you're bidding a job how you determine a basis of that bid, or if someone comes in for a quote, do you usually work on a time and material basis?

Mr. **Williams**. A service organization is primarily the selling of someone's time and experience. So we make a determination of the amount of time and the level of personnel that would be required to complete a study. And then we just put the particular rates that go with those individuals, come up with a sum and hopefully we've anticipated the time that would be required to do that work, and that we'll have money to cover our costs and a little left over to pay part of it to Uncle Sam.

Mr. **Schulze**. Is there a standard profit margin in the industry that competition decrees? Is it 20, 30, or 10 percent or what kind of margins do you get?

Mr. **Williams**. I'd say the goal in our industry is 20-percent return on investment. That probably would translate to less than 10 percent on sales.

However, very few of us meet that goal. We're still trying.

Mr. **Schulze**. Mr. Johnson, do you agree with all that? Do you have anything to add?

Mr. **Johnson**. I do.

Mr. **Schulze**. Tell me how much the halo effect counts, that is the aura from being associated with a nonprofit? Is that just tough competition? Is that something that you can overcome or that's difficult to overcome at any price?

Mr. **Johnson**. Mr. Chairman, I would respond that we enjoy competing against these people because we think we're better. And I won't come here in sack cloth and ashes and tell you that things aren't going well. Things are going well for us.

There is this halo effect that does have to be overcome with each new individual customer.

In my testimony, I cited the letter from the university that outlined how some companies like to go to an educational institution because, in fact, there is this aura effect.

I also listed the companies who come to us. IBM, we do business for eight different locations of IBM. So we are proud of our customer list. So I won't tell you that we're hurting per se.

Our major problem for me specifically is in this area of international business. And it's very specifically Underwriters Laboratories has gone into this international area, and they are, through monopolistic practices, precluding us from entering these markets.

And the irony of it is that they are doing this international business for international customers for the public safety of international people, and they are not paying taxes on the revenues that they are making. It is just absurd. And that's the major problem that I have today.

Mr. SCHULZE. Mr. Carlton.

Mr. CARLTON. Mr. Schulze, please, may I offer an additional comment?

Your earlier line of questioning about salaries and comparisons, I see a somewhat different universe than does Mr. Williams, for example.

I discussed earlier the FFRDCs, and I would point out that salary compensation levels, the total compensation level is very similar at an FFRDC to compensation levels at our company.

I would perhaps disagree a bit with Mr. Williams' comment about university salary levels. He sees a different universe than I do.

Some of the university professors that I deal with and know rather well do extremely well. Many others do not. So there's a wide diversity, I think. And certainly I feel strongly that at the university I'm associated with, namely the University of Texas, we need to do a better job with faculty salaries.

But there is wide diversity in professor salaries, and I think it's important to recognize that point.

Mr. SCHULZE. Thank you.

Yes, Mr. Brong.

Mr. BRONG. Mr. Schulze, if I may address that from another standpoint, the entry salary for our firm, as compared to, as close a comparable position as we can identify at one of the four universities that we find within approximately an hour and a half driving radius of our firm in Pullman.

The entry salary for management personnel would be between $2,000 to $3,000 higher than our entry salary. When we consider the fringe benefit package, we have almost no fringe benefits beyond vacation and absolute basic medical. They have an excellent fringe benefits package. Some of the fringe benefits are indeed monetary though they are indirect monetary.

For example, one of the justifications given, as quoted in the June 2, 1984, Spokesmen Review, for the university's computer store, it's a fringe benefit necessary for recruitment and retention of faculty and staff. That was quoted from the vice provost of the university.

Mr. SCHULZE. What's the director of that bookstore making? Any idea?

Mr. BRONG. No, I don't. I can assure you that the salary is more than what any retail manager of a for-profit firm in our city would make. I would also have to be honest and add that the program that individual is running is managed in an excellent manner. He is meeting the goals and objectives of his employer, and he's probably worth everything that he is paid.

When we look at the competition issue, it is also competition for staff. In the last 24 months, I have lost two staff. Of course, we are having difficulties now. But they are now working for the universities. So this is a significant problem, the salary issue, from our standpoint.

Mr. SCHULZE. Thank you. I thank the panel.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman. I thank the panel.

Originally, it made a lot of sense to promote knowledge, arts and industry written largely in terms of our land grant colleges and universities. We would not have attained the structure that we have today without, I think, those initial land grants in most of the colleges from the Midwest and the West. The great famous ones are land grant colleges and universities in Washington, California, other areas.

One of the difficulties with Washington, and do you have, just for example, what percentage of the student body at Washington State University are from California rather than indigenous to the State of Washington? I think you would find it probably almost half or more.

This is true with all the surrounding States. Therefore, these students are there for the purpose of going to the college or university, and they are not going to stay in the area, and they go back home after they've achieved their degree.

They brag about being a "Cougar" for the rest of their lives, but they usually do it in Anaheim or Los Angeles or Hollywood.

It's also true though, isn't it, Mr. Brong, that Pullman is a kind of a center town for an agricultural area, that the entire eastern Palouse country of Washington focuses on Pullman as a central city, and what's the agricultural economy like in the area? Is it depressed or is it doing well?

Mr. BRONG. Well, as you know, when you discuss an agricultural economy, you're going to get a very wide range of opinions. It depends on what day of the week and which farmer or banker you would ask.

Generally speaking, however, my perceptions of the agricultural economy, as I see it as a city council member, as well as a merchant serving those individuals, is that it is far better off than parts of our country. It is depressed from where it was 5 years ago, but it definitely is on a rebound and upward curve.

Mr. THOMAS. So you have taken all of those factors into consideration, and still you feel comfortable with the evidence that you've presented in terms of focusing on Washington State University as the primary problem for the businessmen as you've outlined it in Pullman?

Mr. BRONG. Oh, yes. One of the main reasons for that, as we find our reorganization process underway, we have focused on doing business from our base in Pullman with clients that are located a hundred or more miles away. And our reorganization is being successful. Our business is growing, and we have yet to reach profitability at the levels required to service past debt. But the market is there, not just in the Palouse marketing area, but in a hundred-mile plus radius. Definitely there are markets there.

Mr. THOMAS. Part of our problem is that we are dealing with a section of the law that covers a broad range of activities, and I think this panel exemplifies that.

To a very great extent, your problems are not with what these universities or State colleges have, but it's what they do with what they have that's the problem.

Now, for the other three gentlemen on the panel, when I read the statute, it says that one of the things that you can set up a 501(c)(3) operation for is "for testing for public safety." This is one of my concerns because then you get into the question of, what is testing for public safety? I think all of us can think of a historical need to stimulate this activity, especially coming out of the late 20th century and all of the problems that we've had in terms of products and consumer culpability and all the rest.

So, for me sometimes, it's the question of maybe addressing the statute itself. I think all of you would agree, wouldn't you, that we're not talking about what these folks are doing isn't good and useful. I mean it is good and useful. That was one of the reasons it was stimulated. It's a question of whether they need the advantage that's provided them in the position that they're in today. How do you create a yardstick to measure that?

Mr. Johnson, my assumption is that you, in your testimony, have no reference to the quality of work done at UL.

Mr. JOHNSON. On the contrary. In my testimony, I do point out, in my written testimony, that they do fine work.

Mr. THOMAS. That they do fine work.

The question I have for you is, and any of you gentlemen in the testing area, if I'm allowed to set up an operation to test for public safety and I do the tests—and I think everybody knows about the toaster cord that has the UL seal of approval on it. We're not really talking about that kind of work that much any more I don't think. We are getting a lot more sophisticated, as you indicated in terms of the testing that you're doing.

But the very nature of testing is that you either find something acceptable to standards that you're testing for or you don't.

My question is what do you do when you don't? Do these folks then provide support for explaining why it doesn't? Do they offer alternatives to bring it up to standards? Do they in fact have facilities which do research and development to aid and assist either in terms of the electromagnetic radiation caging equipment, or structures?

If you're going to do the testing, and someone pays you to do the testing, and you give them the answer and the answer is no, they're going to want additional information than just no, it doesn't meet the test. They are going to want to know what do we need to do to meet the test.

Now, if you extrapolate that from the standard of testing for public safety, you can go almost anywhere, can't you?

Mr. JOHNSON. That's right. That's right.

As a matter of fact, the irony of your question is, is that Underwriters Laboratory does not provide the research and development or the technical backup when a customer indeed does fail the test.

Mr. **Thomas**. Where did the customer get that information?

Mr. **Johnson**. They get that from the for-profit laboratories. That is the business that I conduct. I test. If they fail, we help them solve that problem. Underwriters Laboratory does not do that. That's why your question is extremely ironical.

That's one of the ways that we're able to compete with them in that, and successfully, is that we will offer that service of—we use the term broadly—fixing the product.

Mr. **Carlton**. Excuse me, Mr. Thomas. May I add to that, please?

In my testimony I have a direct quotation from a letter from a member of an FFRDC stating that he can now perform proprietary research on a contract agreement basis. And that was a letter telling me he could do it for Radian Corp.

So I would suggest that while the gentleman speaks to UL, and that's right, and in the case of the FFRDCs, they clearly are offering their services to "fix it," depending upon what the issue is.

Mr. **Thomas**. Well, that's going to be a problem that we are going to have to get into in terms of where we draw the line if, in fact, we keep this testing for public safety, how far does it extend.

Did any of you at any time in your business experience make a conscious decision not to go this route, even though there may be tax advantages? Did you ever weigh it as an option?

Mr. **Williams**. I don't think our firm ever weighed that option because the reason why we were established to begin with is we all had strong entrepreneurial leanings. We wanted to run a for-profit business. I did not have that.

But, to add on to your question, the kind of work that our firm does could be categorized as testing for the public safety in every area that we work in. Because safety is the bottom line of the test result. Will it work or won't it work?

Mr. **Carlton**. I was going to make the comment that a lot of the testing work we do is in the environmental area, that is, is a certain material toxic or is it not, is it hazardous material, and what levels, et cetera.

Thus, we run into the same kind of situation with respect to our service as well.

Mr. **Thomas**. A direct question, Mr. Johnson.

In terms of UL, for example, in setting up facilities to do the VDE testing, do they have to have unique facilities or equipment, or can they utilize equipment that they would use to test domestic?

Mr. **Johnson**. The top off-the-shelf equipment.

Mr. **Thomas**. It would be——

Mr. **Johnson**. In definition of the term "unique," yes, it's unique to the West German market. They are employing off-the-shelf equipment.

Mr. **Thomas**. The question would be the testing equipment that they use to determine the standards, the VDE standards, is off-the-shelf stuff?

Mr. **Johnson**. Yes.

Mr. **Thomas**. Okay. So if they purchase it with their tax-free dollars that they've accumulated, it isn't a unique piece of equipment that would be dedicated to testing for the West German standard for the West German citizen, and you could not use it for an American citizen?

Mr. Johnson. No, that's incorrect. The equipment that they purchase is specifically for testing for the West German VDE regulations. And it could only be used, and the reason is because the regulations for the VDE call for testing in a different area of the spectrum than they do for the FCC.

Mr. Thomas. Was there any challenge to the use of those dollars in purchasing equipment under their charter of testing for public safety, that it extended only to equipment that was not domestic?

Mr. Johnson. There has been no challenge on my part as an individual entrepreneur.

A lawsuit is not something that I would like to sponsor.

Mr. Thomas. I understand.

My other great concern is, and I'll just finish with this, as we get into this area, if you talk about testing for public safety, yes, when you talk about toaster cords and other items, people see that. But testing for the public safety is what you define it as, and it goes into the AIDS testing, the blood testing as we talked about, Radon is going to be a whole new area in which I would think that if I was going to start up an operation, I would look very seriously at going 501(c)(3) if I was going to be able to do anything anybody else could do and look at that margin of difference which is, sometimes for you folks, the different between profit and no profit. That's not a consideration that I would have to make there.

I think that's a very valid concern for us, where we have specific cited areas that people can pursue under 501(c)(3), as broad as testing, which also means not only testing but providing conclusions, results, suggestions, modifications to bring it into some kind of a safety zone. That's a wide open section of the code.

Mr. Johnson. If I can just respond to that.

In my testimony, I presented a letter that I had received from Mr. Bono, who is president of Underwriters Laboratory. And you could broadly interpret his language to me, which came as a result of my challenging him going into these international markets, you could take that letter as literally carte blanche to do any type of testing that he wants to do. I mean there's literally no end to where he could go with that language.

Mr. Williams. Let me carry your example maybe one or two steps further.

What if all of us in the testing field applied for 501(c)(3)?

Mr. Thomas. I guess my question is why didn't you? [Laughter.]

Mr. Williams. Well, it's——

Mr. Thomas. I know. You're from Texas and you're stubborn.

Mr. Williams. You got it.

Mr. Carlton. Mr. Thomas, our basic business is solving problems is the way we address it. And we got into the testing business simply part of our overall business effort to provide engineering and scientific services. The concept then of taking that lump of our business and moving it over into a separate not-for-profit organization we find to be very difficult because the testing is integral to the overall service we provide.

Mr. THOMAS. Just let me say, if I may, I find the ultimate irony, I believe, Mr. Johnson, in your testimony, which was part of a response from the UL Laboratories and the test to determine whether or not they're operating appropriately is whether they put you out of business or not. The question is are you out of business? No. Well, what are you complaining about then? That really turns the whole operation on its head. It's ironic that that's the way they look at the world.

Thank you very much for your attention.

Chairman PICKLE. Thank you, Mr. Thomas. And I want to express my regret to the panel that I haven't been able to be here for the whole hearing. I particularly wanted to hear the testimony from my friend, Don Carlton, who is the president of a very respected and effective organization in my city.

I do understand that you all have given some good testimony.

Now, I would like to ask specifically though—Mr. Carlton, I'll ask you—this committee wants to know how your business has been affected.

You stated that the nonprofits are very huge, highly profit motivated organizations.

Have you given to the committee examples of where you've lost contracts to these kind of competition?

Mr. CARLTON. Yes, I have, Mr. Chairman. In addition, we have many other examples. I simply limited the number that I presented because——

Chairman PICKLE. Could you give to this committee the name of the firm to whom you lost a contract, nonprofit?

Mr. CARLTON. Absolutely. I've given a list of the 39 federally funded contract research and development centers, which was the focus of my testimony. You have that list.

Chairman PICKLE. Is your competition primarily from federally funded laboratories or from universities or from R&D nonprofit organizations or national labs? From whom have you lost business or by whom have you been affected?

Mr. CARLTON. Well, Mr. Chairman, all of those organizations compete with us, and it's not the issue, that they compete with us. I have no problem with the fact that these are good, respected organizations which do outstanding technical work. And they should be allowed to compete, specifically with respect to the FFRDCs.

My problem is that they were set up for a purpose, and that purpose, I think, has gotten lost in the shuffle over the years since they were established.

Chairman PICKLE. Have you lost business, say specifically to my University of Texas?

Mr. CARLTON. Well, the university is not an FFRDC and I was focusing specifically there.

I'm not aware of any specific business that I've lost to the University of Texas.

Chairman PICKLE. Have you lost any business to our so-called Balcones Research Center there?

Mr. CARLTON. No, we really don't compete with them.

Chairman PICKLE. Your competition has been more in the federally funded centers?

Mr. CARLTON. That's correct. That's correct.

Chairman PICKLE. I understand, Mr. Brong, that your business is currently in a chapter 11 bankruptcy proceeding?

Mr. BRONG. That's correct.

Chairman PICKLE. And you think that a good reason for that is the services given by Washington State University, is that correct?

Mr. BRONG. That is correct, sir.

As I look at our market projections, and we did our business plan back in 1981, and ultimately opened in 1982, we were estimating approximately $3.1 to $3.5 million in gross computer sales in our local market area, not from our firm, but from all of the firms that would be in the area.

As we determined the part of the market that we would be able to manage and to control, if you will, we were estimating about $1 to $1.2 million, knowing other retailers would be developing. They did develop. They have all closed. We are the only one still in business. A couple of new ones have developed.

The university currently is selling approximately $2 to $2.2 million in computers. So they have taken that out of the local market.

In addition, they have caused a disruption in the market because no one now knows what is the real and the true price of product. The assumption is that the not-for-profit institution would never overcharge for product and, yet, we have documentation that shows some of their pricing is indeed higher than street prices for the same brands, Spokane, Seattle, Portland, even in our own city.

Chairman PICKLE. Can we cure this by definition? Where would the committee try to draw the line for these changes? Do you have a suggestion?

Mr. CARLTON. I have a couple of thoughts, if I may, Mr. Chairman. I looked at the comment made by the Department of Treasury the other day. You made several comments about that. The Treasury folks address the issue of is the information available in the public domain, as one possible way to decide whether the activity is taxable or is it not. I would argue that perhaps that is not the best criterion, at least in terms of the issue I addressed, namely the FFRDCs. I go back again to the reason why were those organizations set up. They were set up for a specific purpose, generally fairly narrowly defined. For example, Mitre Corp. was there to help the Air Force. Sandia Corp. was set up as a nuclear weapons——

Chairman PICKLE. Would you repeat that? For instance, what?

Mr. CARLTON. Mitre Corp. was set up as a direct support to the Air Force. Sandia Corp. was set up to be a nuclear weapons laboratory and so on. Jet Propulsion Laboratory was set up to support NASA. The problem that I have it is that these organizations are now doing other kinds of work that my firm can do or other firms like mine, can do. So I would argue that if they get outside of that original charter for which they were set up, that is the place to begin taxing these kinds of activities.

Chairman PICKLE. You are saying, then, they were set up for a specific purpose which may be proper and legitimate.

Mr. CARLTON. I have no question about that.

Chairman PICKLE. Once they get their nonprofit status and as they grow and develop, then they expand the operation to a lot of other fields and that is really where the competition is?

Mr. CARLTON. That is correct.

Chairman PICKLE. Let me ask each one of you whether you have reviewed the different recommendations made by the Treasury Department on Monday of this week? Are you familiar with their recommendations or changes that we are suggesting? Well, we are going to give you a copy of their testimony. We want your response to some of those recommendations, and if you have other suggestions, we would welcome them. What I am finding more and more is that witnesses, both nonprofit and for-profit, saying we have been hurt, we have been put out of business, or we are trying to stay in business, but they do not give me examples of exactly what they are doing or they do not give me examples of what they really are paying UBIT, if they are.

We do not have that information from the IRS. The IRS does not even audit them. They say they do, but it is a mighty wee bit. So we need the information from the people who are testifying, the people that are affected by it. And that is what we are trying to get and that is the direction in which we are trying to head. So, I want to thank you. This is an endless sort of a discussion and you never know just where you are going to come out, but we have got to try to draw the line somewhere. We will try to do that as we go forward in the days ahead. So I thank you for your testimony. I appreciate it very much.

[The following was subsequently received:]

RESPONSE OF JAMES W. JOHNSON

A call for "further debate" on this issue ignores the flagrant abuse of 501 (c) (3) we have demonstrated in our testimony in the case of Underwriters Laboratory. You have asked for "examples of exactly what (UL is) doing" and we have provided these. A further example which recently came across my desk can be noted in the letter and a copy of an advertisement received by one of our Minnesota clients from UL. I am incorporating this entire letter and the ad by reference as part of my testimony is response to your question.

The letter is headed up with the slogan "IT'S WHAT'S BEHIND THE TEST THAT COUNTS ... ." This is an obvious attempt to trade on the "aura" of the non-profit providing the service that Amador provides its clients.

The ad is entitled "COMING SOON" and features the UL logo behind block letters for EMI. The letter points out its "new" business and facility in Northbrook and proceeds to "tie" the "added convenience of EMI compliance testing" to UL's ability to provide the UL label "... from the most recognized and trusted name in product testing."

The letter goes on to point that UL and its people "understand what it takes to get your product to market." This new commercial incursion on the part of UL is exactly what Amador does for a living as a tax-paying entity and so, in direct response to your question about our reaction to the Treasury Department's testimony, I totally agree with their comment: "The role of the quasi-governmental, not-for-profit sector should similarly be restricted to that of supplementing and not supplanting, the activities of for-profit businesses."

And we further totally agree with another recommendation and have offered specific examples about UL's activities where in the Treasury Department's testimony it is pointed out that: "These benefits (of not having to pay sales tax, etc.) may be as important, if not more important, than the exemption from federal income tax."

Lastly, the Treasury Department's recommendation that "purely commercial activities ... do not merit tax exemption" and that "specific requirements concerning public dissemination of research results are required to ensure that the public benefits from the tax exemption provided for certain commercial research" speak directly to UL's commercial EMI activity.

In the case of UL the record is clear. A "debate" merely enables this predator to garner greater market share, charge lower prices and ultimately bring for-profit competitors to the bankruptcy courts, as was the case noted in Dr. Brong's testimony today, the computer dealer gentleman who is in Chapter 11. Amador does not wish to have this experience. A delay on the part of your Committee may bring that to be a reality.

We have provided the data and the examples. UL's record is clear. We respectively ask that your first recommendation be to remove the 501 (c) (3) exemption "Testing for public safety."

Thank you, Mr. Chairman, for being allowed the opportunity to respond to your question about the Treasury's recommendations and to point out where Amador has given very specific examples of the flagrancy of UL.

Chairman PICKLE. Now we are going to ask panel No. 4 to come forward. Panel No. 4 will be Ms. Earlene Causey, George Guenther, Eric Peterson, and Susan Perry.

Mr. SCHULZE. Mr. Chairman, if I may, I would like to take this opportunity to welcome George Guenther, who is an old friend and constituent. We are pleased and proud to have him here with us today.

Chairman PICKLE. Mr. Guenther, I will join in welcoming you here. We are glad to know that you are acquainted with, and probably from the district, that Mr. Schulze represents. That makes you a special witness. Glad to have you here.

Mr. SCHULZE. As a matter of fact, Mr. Chairman, I noticed that there are an awful lot of people testifying on this issue from Pennsylvania and Texas. I do not understand why they were selected that way, but it seems very interesting.

Chairman PICKLE. Well, that was unintended, Mr. Schulze, it should be expanded. Earlene Causey is representing the Travel Agents, Inc.; George Guenther is treasurer of the National Tour Association; Eric Peterson represents the United Bus Owners; and Susan Perry, the American Bus Association. Those are different bus organizations, are they? Well, we are pleased to have you and we ask Ms. Causey if you would proceed first.

STATEMENT OF EARLENE L. CAUSEY, NATIONAL DIRECTOR, AMERICAN SOCIETY OF TRAVEL AGENTS, INC.

Ms. CAUSEY. Thank you, Mr. Chairman. Good afternoon, I am Earlene Causey, executive president of VIP Travel Agency of Baytown, Tex., and national director for the American Society of Travel Agents, Inc. [ASTA]. I was also a 1986 Texas delegate to the White House Conference on Small Business.

Thank you for the opportunity to appear before you to address the concerns of approximately 11,000 ASTA members doing business in the United States.

ASTA applauds you for conducting this hearing to review the issue of unrelated business income tax and for focusing on the Federal tax treatment of commercial and other income producing activities of organizations that have tax exempt status.

ASTA does not question the good works of charitable groups, nor the legitimate exempt purpose activities of other nonprofit groups. We do, however, strongly oppose the nonprofit firms who are blatantly commercial in conducting certain activities, thus exploiting their unique status.

We would definitely continue to support the Girl Scouts and Boy Scouts of America in their annual drive in which they may sell cookies or other items, but we would object to their selling cookies, travel services, or anything else on a continuous basis as a means of raising money.

In an atmosphere of difficult economic times, many of the nonprofits conduct commercial ventures in order to survive financially. Several nonprofit organizations have found the sale of travel to be a lucrative source of additional income. ASTA believes that in promoting such travel programs, nonprofits are taking advantage of their tax-exempt status and creating unfair competition in the marketplace.

For example, they are exempt from Federal, State, and local taxes. They benefit from reduced postal rates and have volunteer labor. In addition, nonprofits enjoy a psychological edge because consumers believe they are supporting a worthwhile cause by patronizing their programs.

As late as last week, our local newspaper, the Baytown Sun, printed a press release with a byline from Houston from a nonprofit telling about a trip to Africa at a price of something over $3,000. It could only be classified as an advertisement and not offering anything that we could not compete with.

Chairman PICKLE. What was the publication?

Ms. CAUSEY. The Baytown Sun. This release mailed to numerous newspapers, with a high probability of being printed, would have cost travel agencies in each location several hundred dollars to promote, and the release cost the nonprofit nothing.

Chairman PICKLE. Well, was the newspaper sponsoring the tour themselves?

Ms. CAUSEY. No, sir. This was just a release that was sent out by a nonprofit, just like a press release that anybody else would have sent out.

Chairman PICKLE. Oh, I understand.

Ms. CAUSEY. Yes, sir. I believe it is attached to the copy of my oral statement. It is our hope that Congress will take the initiative to curb the powers of the nonprofits through fair legislative means and prevent them from engaging in commercial travel services for fundraising purposes.

The best illustration of the frustration and concern that travel agents see on a daily basis is the continuous push of the nonprofits and State and local governments to get into the travel and tourism business. A classic example is the city of El Paso, TX, Parks and Recreation Department. The city started by providing local city tour services and also promoting the local arts and crafts. Now, El Paso is a major tour operator conducting group tours all over the globe.

Chairman PICKLE. Through the El Paso Park and Recreation Department?

Ms. CAUSEY. Park and recreation. Yes, sir. Tours include such international destinations as China and Europe and domestic tours to Florida, Yellowstone, Las Vegas, and on and on and on. They average about 10 tours a year. They are created by city employees at city owned senior citizen centers. The trips are promoted through news bulletins sent to all the senior citizen centers operated by the city, but anybody can take that trip. You do not have to be a senior citizen to participate. Some of the functions such as mailing bulletins are provided by volunteers—a service not available to businesses such as ours. And to top it off, the checks are made payable to the city of El Paso.

This practice has nearly destroyed the tour business of our private tax paying tour operators. A few of the tours in the past were put out for bids to travel agents. Often one of the requirements was that a city employee go on the tour free. The senior citizen travel programs are now handled exclusively by city employees and volunteers. Rarely are these tour bargains for senior citizens. They are profit making for the city. Usually the tours promoted can be provided by tax paying private tour operators for the same price and with better facilities and other amenities for the clients.

We feel that this is unfair competition by a municipal government and detrimental to the future of free enterprise. The use of city personnel, both paid and volunteer, also takes time away from services that these tax free centers were designed to provide.

This cancer is spreading. Over the last few years the nonprofit fraternal organizations are getting into the travel business. Masonic lodges and Shrine temples in Texas, and all over the United States, are advertising cruises and tours through nonprofit mailing privileges. These are blatant misuses of selling tools not available to taxpaying travel businesses. Some of the profits earned from the trips are being used for free travel for nonprofit officials and members. They were clearly chartered as nonprofit for other reasons than to promote travel.

Because of the severity and widespread use by many communities of their federally financed bus equipment for profitmaking charter services, the Urban Mass Transportation Authority (UMTA) of the Department of Transportation put forth for final rule and comment the following regulation on April 13, 1987, in the Federal Register:

> With a few exceptions, UMTA recipients will now be prohibited from providing any charter service using UMTA-funded equipment or facilities if there is at least one private charter operator willing and able to provide the charter service that the recipient desires to provide.

ASTA feels strongly that this same test should be applied to determine whether nonprofit organizations and governments should be granted the right to engage in certain commercial activities. Only if there is no privately owned business organization in the community willing to provide the service or sell the product would the nonprofit receive permission to engage in that particular business.

In conclusion, it is the opinion of ASTA that there is no need for a fraternal, religious, educational, or charitable nonprofit organization to promote and/or sell travel services on a continuous basis. There is hardly a town in America with more than 1,000 people that does not have a travel agency who could provide the travel services.

Mr. Chairman, at this time, I would like to respond to the specific questions you asked us to address in ASTA's oral testimony. The first is what specific nonprofit, income-producing activities have caused you and your members harm through unfair competition and to what extent?

We cannot specifically state what the travel agents loss of revenue is because of the nonprofit promoting travel. Travel agents, especially in small communities, are hesitant to publicly point a finger at nonprofits. Their concern is that as a small business entity in the community they would not be able to survive if they publicly denounced the nonprofits commercial activities.

Travel agents only find out after the fact. Our clients usually come into our office and report about their recent travels which were taken as a result of sponsored nonprofit travel programs.

Mark Cooper of Heights Travel Service in Cleveland, Ohio lost six clients to the Orient at a cost of approximately $7,000 per person to AARP. This transaction represents the loss of $700 per person or $4,200 in revenue to Heights Travel.

Harvey Meston of Meston Travel Service in El Paso, Tex. has been in the tour and travel business for 25 years. Mr. Meston provided the travel services for approximately 10 senior citizen centers in El Paso for 2 years before they went into the tour business. He estimates that over the last 3 to 5 years, since he lost the senior citizen business, that he has missed four to five tours a year with 40 to 50 travelers per tour. This would have amounted to between $150,000 and $200,000 in loss revenue to Meston Travel.

Chairman PICKLE. Ms. Causey?

Ms. CAUSEY. Yes, sir?

Chairman PICKLE. I must interrupt you. I notice that you also give an example from the University of Michigan and how they have been affected.

Ms. CAUSEY. Yes, sir.

Chairman PICKLE. And you answer the question about what is the nature of unfair competition. I am glad to have this testimony and I am glad that you have given us this specific information, as we requested. The reason I make this summation is that the House is in session and there is a vote pending, and pending this vote, there will be another one that follows. In view of the fact that we will have two votes, at least, in the immediate minutes ahead, the Chair is going to declare a recess here of approximately 30 minutes and we will resume then, with Mr. Guenther and the other witnesses as soon as we return. But this will give us—we are going to be tied up on the floor for a few minutes. We will just take a 30 minute recess and if you want to get a cup of coffee or something else, why, let's all do that and we will resume again in 30 minutes.

Ms. CAUSEY. Thank you.

Chairman PICKLE. Thank you very much.

[The statement of Earlene Causey and attachments follow:]

Statement of the American Society of Travel Agents, Inc.

Mr. Chairman, Members of the House Subcommittee on Oversight, Committee on Ways and Means, I am Earlene Causey, President of V.I.P. Travel of Baytown, Texas. I am also a National Director for the American Society of Travel Agents, Inc. (ASTA) and Co-Chairman of the Society's Government Affairs Committee.

I am honored to have the opportunity to appear before you today to address the concerns of ASTA, but more specifically to represent the 10,656 active ASTA members doing business in these United States.

Founded in 1931, ASTA strives to enhance the ability of its members to conduct their businesses with integrity and competency, to represent its members in government and in the travel industry and to promote travel and travel agents to the public at large. ASTA, the world's largest and oldest professional travel organization represents over 19,623 members in 127 countries.

ASTA applauds you, Mr. Chairman, and members of the Committee for conducting this hearing to review the issue of unrelated business income tax and for focusing on the federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under Section 501 of the Internal Revenue Code. My remarks today will center primarily on the issue of unfair competition from nonprofit organizations who engage in the promotion and sale of travel and travel services, thus receiving numerous advantages over a tax-paying travel agency such as V.I.P. Travel.

Data about the commercial activities of nonprofits are inaccurate and incomplete. IRS monitoring of this sector is woefully inadequate. When monitoring does occur, IRS officials admit it is often difficult to determine whether a given activity is unrelated to a nonprofit mission (and therefore taxable).

The increased involvement of nonprofit, federally funded, tax-exempt organizations, as well as state and local governments in the commercial side of the travel business, is a major concern to the travel agent community and the taxpayers in general. The Internal Revenue Service (IRS) master file includes over 860,000 tax-exempt organizations. The majority of these entities are organized under IRS Code Section 501 (c) (3) as charitable, religious, educational or health organizations. Between 1946 and 1983, the nonprofit sector grew by more than 1,000 percent. The revenue generated by these tax-exempt organizations has also grown to more than $300 billion per year. Three-fourths of this revenue was generated by commercial activities - sales of goods and services. The nonprofit share of employment nationwide is approximately 10% or 11 million jobs.

In today's atmosphere of difficult economic times, many of the nonprofits conduct commercial ventures in order to survive financially. With drastic cutbacks on the availability of federal grants, the decline in individual private donations, and reduced support from the corporate community, tax-exempt organizations are resorting to profit making ventures as a means of increasing revenue. Several nonprofit organizations have found the sale of travel to be a lucrative source of additional income. ASTA believes that in promoting such travel programs, nonprofits are granted unfair competitive advantages. For example, they are exempt from federal, state and local taxes. They benefit from reduced postal rates and have volunteer labor, as well as other privileges not available to small business entrepreneurs. These advantages allow organizations to offer lower prices or underwrite market entry losses.

It is the feeling of ASTA that the only way we will ever resolve our concerns when competing with nonprofits is for the total elimination when it comes to selling travel and travel services. ASTA does not want to belabor points of inequity. It is our hope that Congress will take the initiative to curb the powers of the nonprofits through legislative means and prevent them from engaging in commercial services for fundraising purposes. ASTA supports the basic concept that no organization be granted nonprofit status, unless they can establish a clear need for their function and can prove that no one else is fulfilling that need in the business community. This safeguards the function of small businesses and insures nonprofit activities remain in compliance with their intended purpose.

ASTA feels that the nonprofits misuse of the low postage rates in marketing travel services gives them a competitive advantage. A typical mailing containing travel promotion brochures which would cost the travel agent 64 cents to mail domestically, costs the nonprofit organization only eight cents. Furthermore, the nonprofits have extensive mailing lists, newsletters, and brochures which they can use to promote their trip at virtually no cost to them. On the other hand, the travel agent would have to pay for all the promotional materials, mailing lists, and newsletters, or hire staff at great expense to do it in-house.

It is our belief that if nonprofit organizations were taxed on unrelated business income generated by their commercial activities and pay the regular postage rates, we would in reality soon see a tremendous turn of events. These organizations would then be forced to compete fairly with tax-paying entities. It is unlikely they would survive.

We are deeply concerned about the empire building attitude of many nonprofits which are so clearly illustrated in the attached article on the National Geographic Society which recently appeared in the Washington Post on March 8, 1987 (See Attachment A).

ASTA does not question the good works of charitable groups nor the legitimate exempt purpose activities of other nonprofit groups. We do, however, strongly oppose the nonprofit firms who are blatantly commercial in conducting certain activities, thus exploiting their unique status. In addition, nonprofits enjoy a psychological edge in that consumers often believe they are supporting or participating in a "worthwhile cause" by patronizing their programs. The "aura" associated with nonprofits as "government sanctioned," leads the public to believe that the products they produce or endorse are of greater quality and reliability. In some cases, the "aura" of the government sanctions allows nonprofits to charge even higher prices and still win the marketshare.

We would continue, however, to support organizations such as the Girl Scouts and Boy Scouts of America to have an annual drive in which they may sell cookies or other items, but we would object to their selling travel or travel services or any other product or service on a continuous basis as a means of raising money.

ASTA has recently become aware of an organization known as INTRAV whose brochure promotes "Advancing Philanthropy Through Travel" (See Attachment B). INTRAV contends that travel is quickly surfacing as a new marketing tool for fundraising campaigns and in developing public relations with an organization's membership. They claim that the trends and benefits to using travel services are many. They include:

1. It builds a relationship with members who are good prospects for fundraising.

2. Members who participate in travel consider themselves closer to the organization and its programs. They will want to become a partner in the future growth and development of the organization.

3. Tourism has become one of the major industries to burst upon the leisure scene. Organizations realizing this find themselves profiting from these enjoyable experiences.

4. Travel provides a means of offering a service that is revenue-producing at no expense to the organization.

In short, it is totally unnecessary for the universities to be involved in promoting such tours. This is a function that can be performed in the community by any qualified travel agent. At present, there are over 28,000 travel agency locations throughout the United States. There is virtually a travel agency within any community of more than a thousand persons. Any community of less than a thousand is linked to a city which would have travel agency outlets. Consequently, there are very few individuals that do not have the ability to directly deal with a travel agency when it comes to their travel needs.

Clearly, it was not the intent of Congress that Alumni Associations be given nonprofit status so they could engage in the promotion of travel and travel services.

For example, the University of Michigan sent approximately 2,500 people on alumni tours last year. It is estimated that major universities such as Michigan, USC and Illinois sent some three to five thousand people on their tours in 1986. The cost for these trips alone would total over $12.5 million. The 10% travel agent commission would have totalled $1.25 million. When one adds the other nonprofits who sponsor similar trips, such as the Smithsonian and B'nai B'rith, the gross sales become very extensive.

In addition, the University of Minnesota sponsored a South Pacific tour March 19-April 4, 1987. The University of Michigan sponsored the exact same tour February 12-28, 1987. Both of them utilized nonprofit postage rates. Further, both are no doubt utilizing the same tour operator. This identical tour or tours of the same area can be obtained by a travel agency any day of the week.

In 1983, ASTA joined with national trade associations whose members face unfair competition from nonprofits to form the Business Coalition for Fair Competition (BCFC). The goal of the BCFC is to build a broad-based coalition to deal with the unfair competition issue at the national levels through legislation and regulatory changes. Such changes will take time, but the effect has begun. Today, ASTA continues to serve as a member of the BCFC Steering Committee.

One significant achievement accomplished by the members of the Coalition was their ability to network together during the 1986 White House Conference on Small Business. The 2,000 delegates, of which I was one, cited unfair competition from nonprofits and governmental bodies as the third most critical problem facing the U.S. small business community. The final sixty recommendations were presented to the Administration and the U.S. Congress. These recommendations have influenced and shaped the legislative agenda on small business issues for the 100th Congress.

The BCFC also cooperated with the General Accounting Office (GAO) in developing a report entitled Competition Between Taxable Businesses and Tax-Exempt Organizations. The report recognizes that tax-exempt organizations rely on a variety of revenue sources, and that they are generally becoming less reliant on charitable sources of revenue, such as contributions and government support, and more reliant on income-producing or commercial activities to fund their operations.

The GAO sent a questionnaire to 1,738 taxable businesses in six industries that reportedly experienced competition from within the tax-exempt community. They were: independent research, racquet sports, veterinarians, travel, tours, and audio-visual communications.

The Coalition also organized its forces to testify before the eight regional 1986 Spring hearings of the Postal Rate Commission (PRC) on the subject of postal rate subsidies. In brief, the PRC recommended to Congress several viable solutions. The recommendation most hailed by the travel agent community was for Congress to recalculate the revenue foregone for appropriations by cutting down the availability of preferred mail rates for commercial or advertising mail uses by nonprofit organizations.

The PRC stated "advertising mail should not receive any subsidy if the thing advertised is not substantially related -- other than by just raising funds -- to the purpose of the nonprofit organization. If a college were to promote a vacation tour as a fundraising device, we believe the advertisements should pay regular, commercial third-class rates."

Mr. Chairman, members of the Committee, no one contends that nonprofits should be excluded from the marketplace. But fairness demands that they enter the marketplace and compete in it on equal terms with other tax-paying businesses therein.

ASTA appreciates the opportunity to appear before the Subcommittee and will respond to any questions that the members may have.

ATTACHMENT A

Geographic Travels Tax-Free

Nonprofit Status Gives Magazine Competitive Edge

By Howard S. Abramson

THE WASHINGTON POST
SUNDAY, MARCH 8, 1987

This is an excerpt from "National Geographic: Behind America's Lens on the World" by Washington Post staff writer Howard S. Abramson, published by Crown Publishers Inc.

As the National Geographic Society's coffers bulged with the fruits of its supremely successful efforts under the golden touch of Melville Bell Grosvenor in the early 1960s, the society underwent a fundamental change. No longer a lean eleemosynary institution begging the world for a chance to fulfill its stated task—"the increase and diffusion of geographic knowledge"—the society began to be a big and lucrative business.

From Gardiner Greene Hubbard's dream of bringing knowledge to the upper classes of provincial Washington, to Alexander Graham Bell's ideal of popularizing geography among the upper middle classes, to Gilbert Hovey Grosvenor's appeal to the vast and growing middle class, under Melville Bell Grosvenor the society became an institution of the masses, and a quite successful and wealthy one. But it was also, as a result of that success, far less a charitable educational institution than it was a giant commercial publisher and mail-order house.

By the end of Melville Bell Grosvenor's 10-year tenure in 1967, the society was selling magazines, advertising space, newsletters, maps, globes, atlases, books and records to the tune of about $500 million a year. Membership—already up to 5.5 million under Melville—was still swiftly growing. This membership was enough to give the National Geographic Magazine the third-largest circulation in the United States, trailing only Reader's Digest and TV Guide. As membership grew, so did the staff that the society found necessary to service members and sell them products.

On top of possessing a good product in an obviously desirable part of the publishing market, the National Geographic Society also had a handful of trump cards up its sleeves. For the society wasn't run according to the rules followed by most of its fellow successful corporations and all of its competition—the commercial book and magazine publishers, atlas and globe makers, record producers and the like—because the National Geographic Society was deemed a "nonprofit" organization under the rules of the Internal Revenue Service.

To inspire altruistic endeavors, the federal government over the years had determined that certain organizations should be exempted from some taxes and regulations to help them survive. This has come to mean that "nonprofits" as a rule don't pay federal income taxes, are exempt from paying local property taxes, pay reduced rates for their postage to the federal government and can offer those who make donations to them deductions on their own federal income tax returns.

Early in the National Geographic Society's history, the taxing authorities in Washington had exempted the society's holdings from the major local source of revenue-raising, property taxes, because of the organization's educational activities. While not paying taxes certainly assisted the society, in its early years it in fact had little property to exempt. But as the society grew, the value of this property-tax exemption also grew.

The city of Washington was under increasing financial strains as World War II loomed; as the government grew in the city, so did the number of organizations that aimed to assist or lobby the government, many of which claimed tax-exempt status as religious or educational organizations. In 1941, Washington's board of commissioners, delegated by the national government to run the affairs of the District of Columbia, decided to take some action: Property belonging to several organizations, including the National Geographic Society, was ordered placed on the tax rolls. The commissioners decided to tax all of the society's assets, except for the library it maintained in the headquarters building, because the Tax Exemption Board ruled that the society was "not an educational institution within the meaning of the tax-exemption statute."

The move restored to the city's tax rolls properties assessed at that time at some $2.3 million, which would earn the District about $40,000 a year. The society's properties represented more than half of the total—$1.27 million—that the commissioners wanted to put back on the books, and would yield some $21,000 a year at the existing tax rates.

The society, then still being run by Gilbert H. Grosvenor, expressed immediate outrage at this move, which was a direct threat to the organization's pocketbook. Grosvenor immediately appealed the decision to the board of commissioners. The appeal was rejected in January 1942, and D.C. Corporation Counsel Richmond B. Keech ruled that the society's property was not used "for educational purposes" as defined by the applicable law.

But the city's commissioners obviously didn't know with whom they were tangling. With Grosvernor leading the way, an appeal for help was made directly to Congress, bypassing the local administration completely. Appearing before a Senate committee, Grosvenor informed the solons that the society was in fact a tremendous asset to Washington, which more than compensated for any tax loss suffered by the city. Over the years, Grosvenor lectured the senators, the society had published 17 illustrated articles on the District in National Geographic Magazine, articles that had a worldwide distribution of more than 16 million copies. Furthermore, Grosvenor said, the society's weekly school bulletins were sent to more than 30,000 public-school teachers in congressional districts all around the country.

On Christmas Eve, 1942, Congress presented Grosvenor and some other Washington-based tax-exempt institutions with a special gift from the taxpayers of the nation's capital: a federal law specifically exempting them from property taxes.

That issue settled, the society returned to its business of making money and expanding. By the end of Melville Bell Grosvenor's tenure, the society's Washington property was assessed at more than $16 million, a conservative figure considering that the building that opened in 1964 had alone cost more than half that amount. At the time, the city estimated its taxes lost by vir-

CONTINUED INSIDE

Geographic a Taxless Traveler

CONTINUED FROM PAGE 1

tue of the society's exemption at more than $500,000 a year. The society's headquarters complex now occupied about two-thirds of a prime city block; nestled between the buildings, the society provided free surface parking for its workers on some of its tax-free land in the shade of large magnolia trees, and thus the society was said to be the only organization in Washington that could afford to offer its employes such an expensive perquisite.

The larger the society got and the more property it acquired, the greater the subsidy that was provided by the taxpayers of Washington. Indeed, by 1979 the society's Washington holdings were assessed at $33 million, the largest of any nongovernmental tax-exempt institution in the city, and would have yielded at least $610,000 a year in taxes. These assessments were well below the fair market value of the properties. In addition to the Washington holdings, the society by this time owned its enormous "Membership Building," where more than 1,000 employes spearheaded the society's mail-order business, magazine billing, and the endless stream of mailings offering memberships, books, films, records and lectures. The 400,000-square-foot building is in Gaithersburg, on a 150-acre tract overlooking an 11-acre pond. That building, which cost some $6 million to construct, and its lavish grounds would have paid some $300,000 in taxes were it owned by a commercial publisher. The society has other holdings, such as the new high-tech printing plant it recently opened in Mississippi, to which it shifted much of its work away from private, tax-paying firms.

After Washington was granted limited home rule by Congress in the 1970s, a new move to limit the spread of tax-exempt institutions sprang up. Two members of Congress urged Washington to move in that direction, and the D.C. Council, led by David A. Clarke, began to react. Clarke, who is now chairman of the council, said in the spring of 1979 that he hoped for quick passage of legislation to harness the tax-exempts. The legislation hasn't been heard of since.

The corporate income of the society, as well as that of its "nonprofit" brethren, also was excluded from federal income taxes—a potentially much more valuable exemption for an exceptionally successful nonprofit organization like the society, for it applied not just to the society's substantial revenue from membership dues but to its millions in advertising dollars.

The society's gross income in 1969 was $60 million; membership at the time was up to 6.8 million, which kept the magazine in third place in the United States, still trailing only Reader's Digest and TV Guide. But the National Geographic's readers were more affluent than the average readers of the other two magazines, and thus were more sought-after, especially by makers and sellers of upscale products.

As the society competed with Rand McNally and Hammond to sell atlases and globes, and the National Geographic vied with myriad publications for readers and advertisers, the commercial firms paid taxes and the society didn't. This gave the society a subsidy with which to undercut competitors, and the society put this edge to good use.

Publishers Weekly, a publishing-industry trade magazine, reported in 1973 that "there has long been a feeling in the publishing world that tax-sheltered publishing falls into the same general category as government publishing and that there is an element of unfair competition in both. . . . As a nonprofit institution, the Geographic can also sell advertising at less cost than commercial publishers. The publishers of the late Look and Life [recently revived as a monthly] must frequently have looked with anger as Cadillac or other juicy ads passed them by and ended up in the Geographic."

Rand McNally and Hammond had considered a legal challenge to National Geographic's tax-exemption advantage, but eventually decided to follow other strategies. Their efforts, and those of other publishers, apparently inspired the IRS to take another look at nonprofit organizations that engage in commercial activities. In December 1967, in a landmark IRS ruling, the National Geographic and similar publications were stripped of one of their tax exemptions. In that year alone, the society sold 351 pages of high-income advertising in the National Geographic.

Up to that time, most courts had ruled that no matter how nonprofits raised their money, the revenue was not to be taxed. Now, however, acting "to eliminate a source of unfair competition," the IRS ruled that ad revenue from the Geographic would be subject to federal income levies.

The IRS regulations raised a storm of protest from the tax-exempt publishers, and especially from the National Geographic Society, but the rules weathered a determined lobbying campaign aimed at getting Congress to scrap them. They were confirmed by Congress as part of the Tax Reform Act of 1969, giving the IRS a much firmer legal standing in the face of any court challenges.

While the legislation seemed to tap justifiably into the excess profits of the few high-income tax-exempt magazines, it created a new tax headache for the 700 or so publications put out by other less-endowed nonprofits. At the time of the ruling, Philip Abelson, editor of the prestigious if unwealthy Science magazine, a publication sponsored by the nonprofit American Association for the Advancement of Science, said, "We're not making any money from our advertising. But now we're going to have to go out and hire lawyers and bookkeepers to prove it. It's just a nuisance for us, and the U.S. won't get a dime out it."

CONTINUED

COPYRIGHT CROWN PUBLISHERS WASHINGTON POST 1987

But whether this IRS ruling and the resultant legislation has had any serious effect—or any effect at all—on the National Geographic Society's coffers is unclear. In 1970, after the IRS ruling was incorporated into the 1969 tax law, one New York Times Magazine writer said the law "was drawn so leniently that the Geographic's lawyers and accountants believe that it still won't actually have to pay anything anyway." The writer didn't quote anyone at the society, but the context of the quote makes clear that the conclusion was presented to him by informed sources at the society.

Whether the society pays such taxes is unknown, since neither the IRS nor the society is willing to talk about it. What is known is that for the year 1984, the society told the IRS that it raised $29.6 million in advertising.

As if tax exemptions weren't enough of a subsidy for the National Geographic Society, the organization also took full advantage of another perquisite offered by the Congress: discounted postal rates. These discounts are offered to nonprofits on the assumption that their funds are limited and they thus need help with the costs of billing their members or distributing their appeals for funds. To the National Geographic Society, this assistance took a little different turn.

In 1976 alone, the society spent $3 million on third-class mailings to sell memberships and products. Had it paid the regular rates, its bill for the year would have been $9 million. Also during the year it spent about $3 million on second-class mailings for its publications, about $2.5 million less than it would have cost its commercial competitors to mail the same amount of material.

No doubt at least partially because of this discount mailing privilege, the society sends out an almost endless stream of full-color, high-quality mailings pitching its various goods and membership plans, the envelopes for each of which are clearly marked "Non-Profit Org." By 1984, according to society officials, the postage subsidy was saving the organization $10 million a year.

As a result, the society has become the 15th-largest mail-order house in America, according to Maxwell Sroge, a consultant who specializes in that industry. "[I think] they have really an unfair advantage" over the competition due to their tax-exempt status and their reduced postage charges. Sroge estimated that the society mails "several hundred million pieces" of promotional material every year.

All of these tax subsidies are granted to the National Geographic Society because of its educational functions and its status as a nonprofit, meaning that no stockholders withdraw profits as dividends. The nation's tax laws as written today seek specifically to exclude from tax-free status organizations "operated for the primary purpose of carrying on a trade or business for profit" solely on the ground that their profits go to a charitable organization—themselves.

But looking at the society's tax returns raises puzzling, and primary, questions. Why is the National Geographic Society considered a nonprofit organization? For what educational purpose does it exist? Other than for dispersal of income, how does it differ from the nation's for-profit publishing conglomerates?

Society founder Gardiner Greene Hubbard's goal was to create an organization of inquisitive, high-minded men both to help chart the globe and to inform other intelligent, curious people about their discoveries—in short, to promote "the increase and diffusion of geographic knowledge." His sucessor, Alexander Graham Bell, wanted to fund this research, exploration and publication chain by selling memberships to the masses, but still keeping the society focused as an educational organization. Gilbert H. Grosvenor's goal was to funnel 15 percent of gross revenues into exploration and research.

And the society's formula for commercial success was certainly succeeding. From the $60 million in gross income in 1968, the society's gross revenue had reached $130 million in 1976. By 1984, the National Geographic Society was grossing $326.8 million, had a net worth of at least $198 million, and recorded "profits" of more than $17 million, even under the peculiar rules that apply to it. In that same year, its interest and dividend income alone amounted to more than $18.7 million. And 1984 was far from a banner year—the year before, the society had "profits" of $30 million on similar gross revenue.

Yet astonishingly, in 1983 the National Geographic Society awarded research and exploration grants totaling only $3.18 million, less than 1 percent of its gross revenue. And even that figure is misleading, since many of those "grants" led to articles for the National Geographic, and would perhaps have been more accurately classified as publishing expenses. The next year, the society reported that its research grants jumped to $4.3 million. But most of that increase involved projects destined for publication in a new research journal of very limited circulation that the society was preparing.

The society also spent about $3.4 million during 1983 on its small museum on the ground floor of one of its headquarter buildings, on running its news service and library, and in charitable contributions and memberships. In that year, the society earned some $170 million from membership dues, almost $98 million in publication sales, $13 million from a new children's magazine, National Geographic World, and $2.5 million from television films and documentaries. It reported a "surplus" of $30 million.

What must be taken into account when assessing the society's finances is that federal policies actually encourage the society to

CONTINUED

CONTINUED FROM PAGE 3

spend money. While not part of IRS and Postal Service regulations, agents' field practices have evolved into a perceived rule that, in order to retain its tax-free and reduced-postage status, 80 percent of the membership dues of an organization must go into the production of that publication. In other words, if a publication is a big money-earner, it had better cost the sponsoring organization a lot to produce. The society reported that it spent $172.4 million preparing the 12 issues of the National Geographic in 1983, about $14.67 million an issue.

As a result, the society has developed a well-justified reputation as a big spender. Its facilities are unsurpassed in the world of publishing, its technical facilities are state-of-the-art, and while its salaries aren't extraordinary, its lavish expense accounts are legendary. Writers and photographers are encouraged to spare no expense in pursuit of their quarry, and are often advised to "go first class."

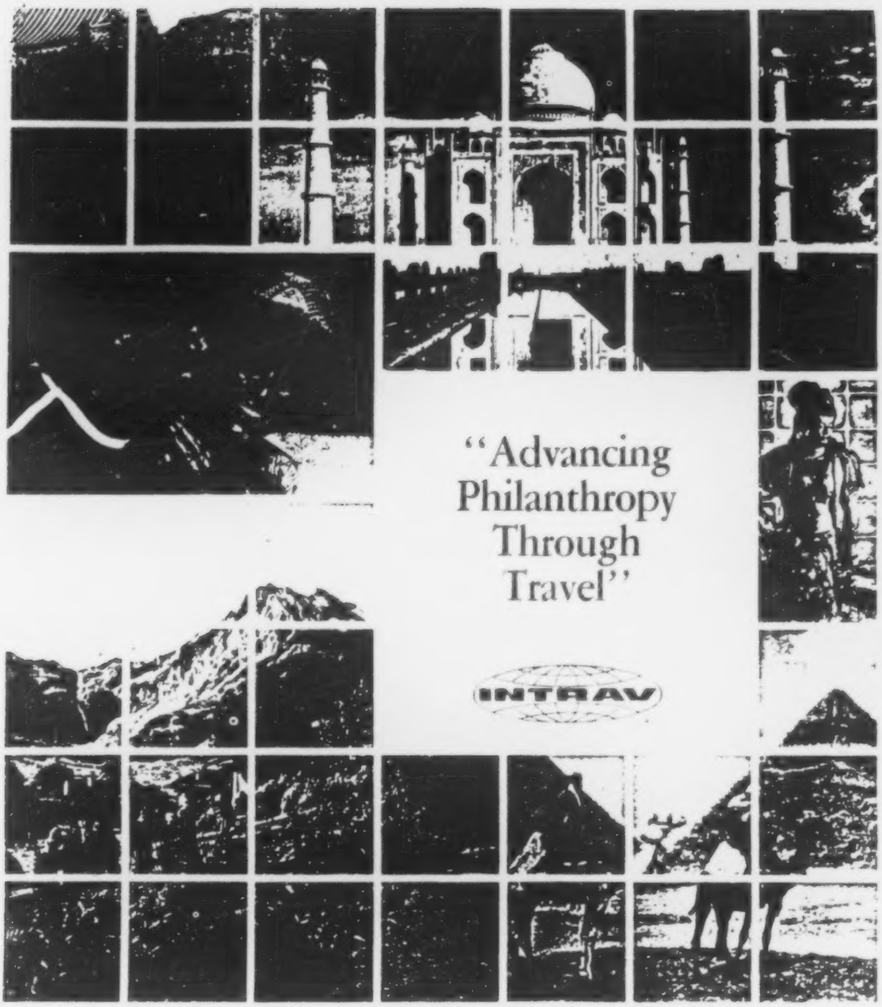
As explained by a writer for The Washington Monthly, the IRS and Postal Service regulations don't "confront the possibility that there might be some nonprofit organizations that take in far more money than they spend, like the National Geographic. These organizations work hard to eat up their net income by artificially raising their overhead—hence the high salaries, the dining rooms, the free parking, the gleaming buildings, the generous investment portfolio. In a corporation that isn't protected by nonprofit laws, these perquisites might be protested by stockholders as unnecessary, but because the Geographic is nonprofit, it doesn't have to report any financial information to the members of the National Geographic Society, who fund it. The Geographic's members know far less about where their money goes than do the stockholders of most corporations."

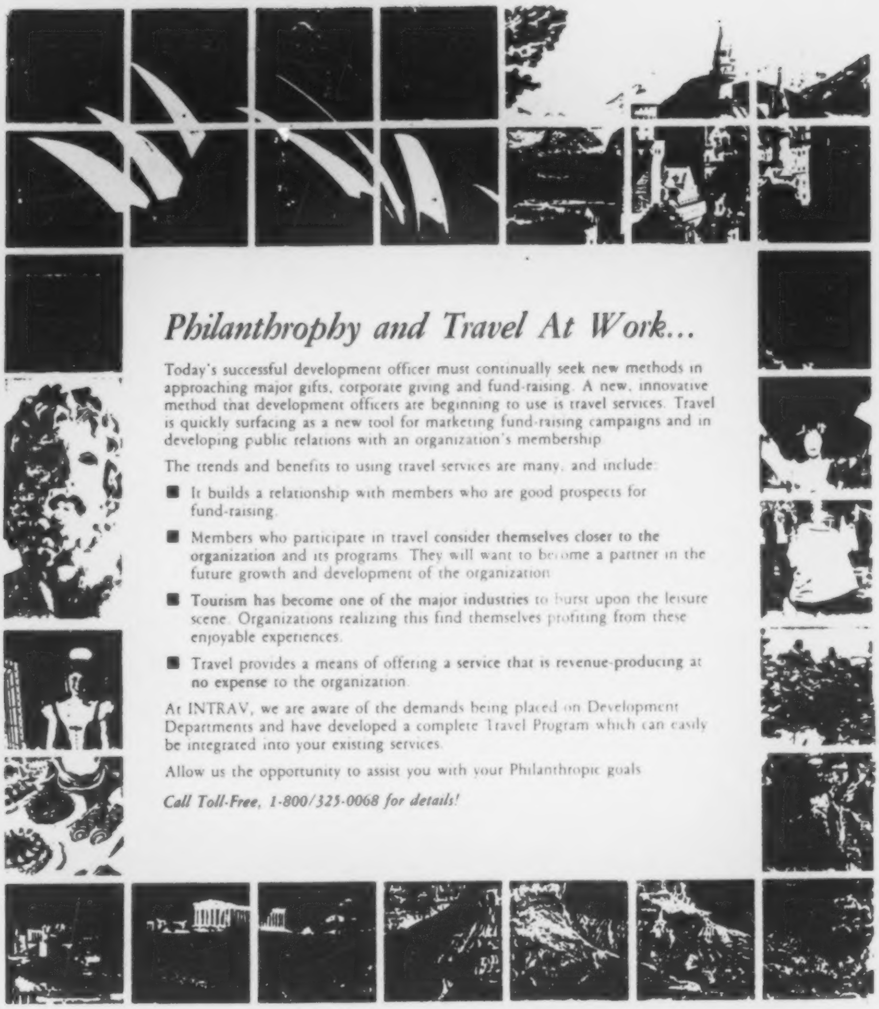
One IRS official told the author, "It is very difficult for us to judge what is educational and what isn't. . . . Where do you draw the line? I don't know. . . . What has evolved in practice is a general test of an organization's primary purpose. . . . If the primary purpose of an institution is an allowable charitable purpose, then the organization will be tax-exempt. . . ."

To Gilbert H. Grosvenor in 1922, being nonprofit was something he was proud of. "There is another point I want to make about these members of the Society. They do not merely get—they also give. The magazine, for instance, is not run for profit. No money dividends are paid to anyone. The treasury balance now is on the credit side of the ledger, but it is spent in increasing the scientific knowledge of the world in which we live. . . ."

But by the time of Gilbert M. Grosvenor's reign, which began in October 1970, The Washington Monthly had a very different view of the operation. "Mainly, what the government is subsidizing [through tax-exemptions] is an expensively operated magazine, put out for the entertainment of an affluent readership and filled with innocuous articles on faraway places—something that, it seems, the readers ought to pay for themselves without the help of the nonreading public."

International Communications Industries Association
3150 Spring Street, Fairfax, VA 22031-2399
(703) 273-7200


"Advancing
Philanthropy
Through
Travel"
INTRAV



Philanthrophy and Travel At Work...

Today's successful development officer must continually seek new methods in approaching major gifts, corporate giving and fund-raising. A new, innovative method that development officers are beginning to use is travel services. Travel is quickly surfacing as a new tool for marketing fund-raising campaigns and in developing public relations with an organization's membership.

The trends and benefits to using travel services are many, and include:

- It builds a relationship with members who are good prospects for fund-raising.
- Members who participate in travel **consider themselves closer to the organization** and its programs. They will want to become a partner in the future growth and development of the organization.
- **Tourism has become one of the major industries** to burst upon the leisure scene. Organizations realizing this find themselves profiting from these enjoyable experiences.
- Travel provides a means of **offering a service that is revenue-producing at no expense** to the organization.

At INTRAV, we are aware of the demands being placed on Development Departments and have developed a complete Travel Program which can easily be integrated into your existing services.

Allow us the opportunity to assist you with your Philanthropic goals.

Call Toll-Free, 1-800/325-0068 for details!

INTRAV... The Deluxe Travel Company

INTRAV specializes in the design and operation of deluxe travel programs for discriminating professional people throughout the United States.

Since 1959, we have built an outstanding reputation in the travel industry for providing only the highest quality and service. It is this complete and uncompromising attention to detail that keeps so many passengers returning year after year.

Our professional planners travel the world choosing the best each area has to offer. Then we put it all together into one great trip that others cannot successfully duplicate because of our outstanding service commitment.

These trips are not sold to the general public. They are operated exclusively for people from the same social and economic background.

We feature a wide selection of unique worldwide destinations not found in ordinary commercial travel.

INTRAV takes the trouble out of your travel so you go relaxed and carefree

- A wide selection of exclusive travel programs to exciting destinations, at a wide range of prices and durations.
- We carefully select ships, hotels, restaurants and transportation—only the best quality.

PREDEPARTURE ASSISTANCE

- Full pretrip assistance by a highly trained and experienced sales/reservations staff.
- In-depth travel literature to answer all your questions about the trip.
- Detailed assistance regarding passports, visas, inoculations, weather, clothing recommendations and packing suggestions.

FULL ASSISTANCE DURING THE TRIP

- A specially trained and experienced Travel Director is with you throughout the trip to coordinate all details for you.
- A Cruise Director on all cruise ships.
- All airport/hotel/ship/train transfers for you and your luggage.
- Preregistration at all hotels with no check-in wait required.
- INTRAV Hospitality Desk, with trained hosts, in each city to arrange sightseeing, shopping, nightlife and other activities.
- Full American breakfast in each city and special group dinners. All meals on board cruise ships.
- Complimentary Get-Acquainted Cocktail Parties and special events.
- All tips and taxes for transportation, hotels and baggage handling are included.
- No regimentation—do as you please. Explore on your own, or participate in optional, exclusive sightseeing tours.

MANY EXTRAS INCLUDED

- Automatic $250,000 Flight Insurance Policy for each passenger at no additional charge.
- Deluxe oversized flight bag and luggage tags.
- Deluxe passport wallet and engraved name badge.
- **Guaranteed** departure of your INTRAV travel program.

THE BEST DELUXE TRAVEL VALUE

- INTRAV's competitive price gives the most value for your travel dollar. Our quantity buying of air, hotel and other travel components allows us to pass on the savings directly to you without a travel agent middleman.

TRAV.
enture
eck
Here

INTRAV... First in Personal Service and Attention

No other travel company devotes so much extra time to personal service and attention to every detail. Each INTRAV passenger is treated with individual concern, from reservation until return.

A staff of over 100 dedicated travel experts takes care of all the details with a personal touch.

Specially trained Travel Directors extend their friendly companionship as they go out of their way to assure the comfort and happiness of every traveler.

We please the most discriminating passengers... proving again and again that INTRAV is the only way to go.

For More Information,
Call Toll-Free 1-800-325-0068

Or Write,
INTRAV
7711 Bonhomme Ave.
St. Louis, MO 63105-1961

Chairman PICKLE. I will ask the subcommittee to come to order and ask our guests to please take their seats. I believe when we recessed, the next witness scheduled to testify was Mr. George Guenther, representing the National Tour Association. Mr. Guenther?

STATEMENT OF GEORGE GUENTHER, TREASURER, NATIONAL TOUR ASSOCIATION, INC.

Mr. GUENTHER. Thank you, Mr. Chairman. I am president of Talmage Tours in Philadelphia and I am, as you observed, appearing today on behalf of the National Tour Association. The National Tour Association has been incorporated for 36 years and is the largest domestic, group travel association in North America, with over 3,000 members. The nucleus of our organization is the over 500 tour companies which sell pre-packaged or specialized tours to the general public and to pre-formed groups. Mr. Chairman, we have submitted detailed testimony and I shall confine my testimony to a few points and some specifics. I would like to express my appreciation and that of the National Tour Association for the effort this subcommittee is undertaking with these hearings.

Commercial activities of non-profit organizations, which we view as unfair competition, have grown to such an extent, that they are clearly having a profound, negative affect on many segments of our Nation's small business community, including especially, the tour industry. In May of this year, the National Tour Association completed a survey of our tour operator members. Several key findings of that survey are one, tax exempt competition exists and is a problem for 89 percent of the respondents to this survey. Two, 88 percent report that nonprofits offering comparable tours do so at prices, which on an average, are 22 percent less than the respondents'. We view this as significant. Now some specific examples of the kind of problem we face.

I cite first, Mr. Chairman, an organization called New Jersey Transit Tours and I hold up their current 1987 tour catalogue. New Jersey Transit Tours are a wholly owned subsidiary of the State of New Jersey's Department of Transportation. New Jersey Transit has been running tours for at least 12 years. Obviously, the taxpayers of New Jersey support this operation. In addition, much of its bus equipment is purchased with Urban Mass Transit Administration (UMTA) funds from the Federal Department of Transportation. New Jersey Transit, over the years, has flattered my company by imitating our literature and offering tours bearing a remarkable similarity to ours, with, of course, one major difference. Their's are always less expensive.

I would like to give you some 1987 examples. Now we both offer a tour to Williamsburg, VA, and Busch Gardens, a 4-day tour. My price for that tour is $319. New Jersey Transit's price for that tour is $250. We both offer a 4-day tour to Vermont. My price for that tour is $319. New Jersey Transit's price is $300. We both offer a tour to Nova Scotia, a 9-day tour. My price for that tour is $969. New Jersey Transit's price is $650, quite substantial differences. Needless to say, New Jersey Transit, as a part of the New Jersey Department of Transportation, pays no State or Federal taxes and is technically not even within the scope of this hearing today. But it is, nonetheless, a very real, and very unfair competitor for my company.

Now another example—a rather vivid one. I hold up an enlarged page from the Sun City, Arizona News Sun. I would draw your attention to column 1 of this page. Column 1 is filled with three for-profit travel businesses advertising their travel programs for which they obviously paid advertising rates. Columns 2 and 3, two-thirds of the page, are filled by a broad variety of nonprofits promoting their trips at no charge. Included among those offering tours on this page, are three churches, three AARP chapters, one VFW, the Arizona State University, the Telephone Pioneers, and many other similar organizations. And the trips they offer range from 1 day to 17 days in length and include Caribbean cruises and tours to Europe.

The same sort of favored treatment for nonprofits can be found in newspapers all across America. Obviously, Mr. Chairman, there is no easy solution to this problem or these hearings would not be necessary. We suggest, however, that the subcommittee consider a few suggestions. One, acknowledgement that a problem exists. The subcommittee should, in its final report, recognize that the problem of unfair competition does, in fact, exist. Such recognition will add to the growing impetus to rectify the inequities which now exist in the marketplace.

Two, enforcement of current laws. The unrelated business income tax provisions, in their current form, create difficulties in terms of interpretation and administration. And the huge numbers of non-profits and their increasing commercial activities, present enforcement problems. However, these impediments should not be allowed to obscure the fact that a very real need for greater enforcement exists, nor should these difficulties be prohibitive to that enforcement. Tax laws related to for-profit businesses are rigorously enforced. No argument can be mounted to justify any less in regard to nonprofits.

Third, abolish relatedness tests of unrelated business activity. Action on the unrelated business income tax is required now. We strongly recommend that the relatedness test be abolished. In its place, we are advocating that all profit from a trade or business regularly carried on by a nonprofit, be subject to taxation. Commercial activity is commercial activity, whether it is conducted by for-profit or nonprofit and should be equally taxed.

Fourth, consider other legislative remedies. This subcommittee, and other appropriate bodies at the Federal and state levels, should undertake further investigation focused on identifying other legislative remedies to unfair competition. This multifaceted problem must be addressed on a number of fronts. Mr. Chairman, it well may be that the tour operator industry is the most severely affected of all by nonprofit competition because it is so easy to pirate our product. We ask your help to remove the unfairness we find today in our marketplace. Thank you.

[The statement of George Guenther follows:]

Statement of the National Tour Association

My name is George Guenther. I am President of Talmage Tours located in Philadelphia, Pennsylvania. I am appearing here today on behalf of the National Tour Association. I serve as that organization's Treasurer.

The National Tour Association is the largest domestic group travel association in North America with over 3,000 corporate or company members. This membership includes tour suppliers, i.e. hotels, restaurants, airlines, bus companies, sightseeing attractions and others. Our Public Sector Organization category includes destination marketing organizations such as state travel offices, local convention and visitors bureaus and chambers of commerce. Our third category, and the nucleus of our organization, is the over 500 tour companies which sell pre-packaged or specialized tours to the general public and to pre-formed groups.

I would like to express my deep appreciation and that of the National Tour Association for the effort this subcommittee is undertaking to review the commercial activities of nonprofit organizations. These activities, which we view as unfair competition, have grown to such an extent that they are clearly having a profound negative effect on many segments of our nation's small business community, including the tour industry.

During my remarks today, I will be reviewing with you the commercial and other income-producing activities of nonprofit organizations, particularly as those activities relate to the tour industry. I will also review the Federal tax treatment of those organizations and provide recommendations in that regard. Occasionally and briefly I will depart from the specific focus of these hearings to explain the full scope and impact of nonprofit commercial activities. We feel that it is of critical importance that the subcommittee have an understanding of the multifaceted problem of unfair competition.

I would like to set the stage for these remarks by first quoting an excerpt from the January 5, 1987 issue of Newsweek and then offering a statement from one of our tour operator members.

Within the Newsweek article entitled, "There's Big Money in the Nonprofits," the following statements are made:

> Nonprofit organizations don't want your charity anymore, they want your business. To get it they're stepping aggressively into the for-profit world: hospitals peddle medications, universities sell computers and scientific societies market videotapes. All told, tax-exempt institutions are one of the fastest-growing segments of the economy with annual revenues of more than $300 billion - or about 8% of the gross national product. They're big employers too: in the Northeast the 100 largest nonprofit firms employ more people than the region's 100 leading industrial companies...

The following very succinct statement comes from a Pennsylvania tour company, "If nonprofit organizations keep selling low price tours we will soon close our doors and go out of business." The intensity of this problem, as reflected in this tour operator's statement, has resulted in the National Tour Association formally designating unfair competition as our top priority issue for 1987.

Mr. Chairman, as I continue with my testimony, I would request that you and the subcommittee bear in mind a simple, yet very powerful question. That question is simply, "What is fair?" I am confident that as long as all parties involved in this issue approach it from the standpoint of attempting to hammer out a fair balance between the interests of nonprofits and for-profits, our results will include a sense of mutual respect and a knowledge that we have done what is right.

Tour Industry Background

I would now like to discuss the organization and the industry I am representing today. The National Tour Association's three membership categories reflect the partnership and the networks which make up the group travel industry. Ours is an exciting and dynamic industry, yet one which is encountering unfair competition in critical proportions.

In November of 1982, Congress deregulated what was referred to at that time as the tour broker industry. Prior to deregulation, in order to transport groups across statelines, tour operators had to be licensed as a broker by the Interstate Commerce Commission, and such licenses were difficult and expensive to obtain. As a result of deregulation, overnight, anyone could become a tour operator. We were suddenly faced with the challenge of regulating and policing ourselves - a challenge which we faced head-on and in my opinion have met in a very successful fashion.

The National Tour Association incorporated many of the superceded ICC licensing requirements into our own membership standards, including experience requirements for members' managerial employees. Beyond this, tour operator members are required to maintain a minimum of $1 million in errors and omissions and professional liability insurance. Additionally, members are provided with a comprehensive educational program.

In all of this our point is a simple one. Developing and operating safe, quality, and professional group tours requires a high level of expertise. It is not an endeavor in which one can engage as an avocation and still provide a quality product to the traveling public. All too often our friends in the nonprofit sector do not recognize this, with the affected parties being those who choose to purchase their tours.

Definition of Unfair Competition

With this as a backdrop, I would now like to review with you the issue of unfair competition as we have experienced it. First, for purposes of our testimony and to perhaps provide each of us with a frame of reference for this discussion, I would like to offer the following as a definition of unfair competition: Unfair competition occurs as a result of a government subsidized entity or nonprofit organization's frequent and ongoing sale of goods or services, which are also sold by the private, for-profit sector; with privileges of the organization's nonprofit status employed in the development, promotion, sale and/or operation of those goods or services.

This definition should be considered on the basis of its component parts. First, we refer to government subsidized entities, as well as nonprofit organizations. Clearly the focus of the subcommittee's attention is on nonprofit organizations. However, we make note here of government entities in order for you to appreciate the scope of the problem we are facing. In addition to the multitude of nonprofits which engage in commercial activities and the many competitive advantages they have at their disposal, we must also contend with municipal parks and recreation departments and other numerous agencies of government which choose to enter the group travel market. Included with these are organizations whose activities or equipment are subsidized by federal, state or local governments.

The next component of our definition refers to "the frequent and ongoing sale." We qualify the reference to selling goods or services in this way to make it clear that we are not objecting for example to a church's periodic bake sale, nor to efforts such as the Girl Scouts annual cookie sale campaign.

In contrast to these infrequent or irregular sorts of commercial activities, we repeatedly see promotional material from nonprofits reflecting comprehensive, year-round tour programs. In one instance, a wholly-owned subsidiary of a bus company owned by a state's department of transportation copied the size, style and many of the tours from a for-profit operator's annual tour brochure and presented it to the public as its own tour program. Often, the only way to distinguish a nonprofit tour brochure from a tour operator's brochure is by noting the much lower prices the nonprofit can charge and the nonprofit mailing permit on the outside of the brochure.

Our definition of unfair competition also refers to "goods or services, which are also sold by the private, for-profit sector." This again demonstrates that we do not approach this issue in an unrealistic or unreasonable way. If there are goods or services which the for-profit business community is unable or unwilling to produce or offer, then one would be rather foolish to suggest that nonprofits should be unable to do so.

The last part of our unfair competition definition is "with privileges of nonprofit status employed in the development, promotion, sale and/or operation of those goods or services." Herein we find the crux of the issue of unfair competition. Organizations are afforded a great number of privileges by virtue of their nonprofit status. First and foremost among these is their tax-exempt status. It is important to bear in mind that when a tax exemption is provided at the federal level, that exemption is usually replicated at the state and local levels.

Further, it is our opinion, although difficult to substantiate, that the tax that many nonprofits should be paying - the unrelated business income tax - is largely being ignored. To quote again from the Newsweek article referred to earlier, "...nonprofit managers take pride in stretching the loosely written law - while the IRS, strapped with the vague statute, prefers to turn a blind eye." I should point out that there have been recent indications that the previously "blind eye" is now beginning to see the light.

Preferred postage rates represent another major privilege as does in many cases the receipt of public subsidies and exemptions from certain regulatory requirements.

The privileges I have cited thus far are those which are afforded by public policy. There are others which result from public perception. These include free advertising, access to volunteer labor, availability of donations and the public's view that nonprofit services are somehow more virtuous than those offered on a for-profit basis.

All of these privileges represent major financial advantages enjoyed by nonprofits in commercial activities carried out in competition with for-profit business offering the same services. Little or no overhead and low operating costs translate into artificially deflated prices against which for-profit businesses cannot effectively compete.

Now let me tie our definition of unfair competition back together. To repeat -- unfair competition occurs as a result of a government subsidized entity or nonprofit organization's frequent and ongoing sale of goods or services which are also sold by the private, for-profit sector; with the privileges of the organization's nonprofit status employed in the development, promotion, sale and/or operation of those goods or services.

If the use of various nonprofit privileges as competitive advantages represents the primary form of unfair competition, there may also be a secondary form. We are concerned that some nonprofits, albeit a minority, are able to amass rather sizeable surpluses or reserves of funds. Reserves, in and of themselves, are not the issue. Any organization, be it nonprofit or for-profit, should attempt to maintain a sufficient surplus of funds in the event of financially disruptive unforeseen circumstances. Although this point may represent a departure from the subcommittee's purpose, we believe it is deserving of attention in the wider context of unfair competition.

Above and beyond the level of necessary protection, questions arise with regard to nonprofits' reserves. Should not excess reserves be reinvested into the particular purposes for which the nonprofit was formed? Should not excess reserves be precluded from further enhancing or expanding the unfair competition activities which served to create the reserves in the first place? This is an area to which we hope the subcommittee will direct its attention.

Position Regarding Nonprofit Organizations

Up to this point, we have discussed and defined unfair competition in general terms. In specific terms, I would like to mention briefly the types of nonprofit entities from which the tour industry tends to encounter unfair competition.

Results from a 1986 survey of National Tour Association members reveal the following types of organizations which have entered the tour market: colleges and universities, senior citizens groups, fraternal organizations, churches, local government, civic clubs and alumni associations.

As this list is reviewed, one may question the wisdom, particularly in a political context, of raising objections directed toward a group of organizations which includes senior citizens groups, church and fraternal organizations. It seems almost un-American!

The point, Mr. Chairman, is that we are not attacking these organizations. These particular groups and the many other nonprofit organizations make a critical contribution to our society. Further, it is our position that the various nonprofit privileges cited earlier - both those derived from public policy, as well as from public perception - are appropriate when consistent with the fundamental purpose of their charter. However, the utilization of these privileges in the course of engaging in commercial activity in competition with for-profit business is not appropriate. When these privileges are used in competition against businesses which do not possess them, they are no longer privileges -- they are abuses and they are unfair.

We concur with John W. Johnson, CAE, and Chairmen of the American Society of Association Executives (ASAE) when he stated in the May issue of Association Report, "It is reasonable to assume that allegations that some tax-exempt organizations are engaged in unfair competition are accurate... Even when a small number of tax-exempts engage in unfair activities, this causes problems for everyone, and we are sensitive to the concerns of all who participate in the marketplace."

Still, I must re-emphasize that we are not attacking nonprofit organizations. The organization I am representing today is it itself a nonprofit association and those members which comprise our Public Sector Organizations category, as well as some of our tour supplier members, are themselves nonprofits. Therefore, again, we are clearly not battling the nonprofit organizations. However, we are unhesitatingly and aggressively objecting to the unfair activities carried out by many nonprofits.

National Scope of Unfair Competition

Finally, after several years' effort, the issue we discuss today, as your hearings attest, is now being recognized as one which is national in scope, and which crosses over into virtually every industry. I am sure you are aware at last year's White House Conference on Small Business, delegates from throughout the U.S., after considering hundreds of issues, ranked unfair competition as the third highest priority among the final sixty issues ratified.

Also last year, the U.S. Postal Rate Commission conducted a study resulting in recommendations to Congress that nonprofits' ability to use preferred postal rates in conjunction with commercial activities be curtailed. Our industry was particularly heartened by the fact that the Commission was sensitive to our difficulties when it recommended that the use of the preferred rates be prohibited in the promotion of travel services.

Just recently, the U.S. Department of Transportation implemented new regulations prohibiting Urban Mass Transit Administration (UMTA) recipients from engaging in charter service operations if there is available a willing and able private charter operator. Although these regulations contain various exceptions to the basic rule, they are nonetheless a most helpful step forward in returning fairness to the transportation marketplace.

While we applaud these efforts, they are only a beginning. With each new day the problem grows in scope and magnitude.

Earlier, we noted the $300 billion economic impact of nonprofit revenues and its 8% share of the gross national product. You should also know that there are over 850,000 nonprofits contained in the Internal Revenue Service master file. This compares with the 99,000 nonprofits which were in existence in 1946. The report issued in February of this year by the U.S. Government Accounting Office (GAO) notes this growth and an accompanying increase in commercial activity. The report states, "As tax-exempt organizations have evolved over the years in terms of number and activity, many appear to have become generally more reliant on income-producing or commercial activities and less reliant on support from contributions, government grants and dues." The report adds, and in our view, adds ominously, "Indications are that this trend is continuing."

Unfair Competition and Its Impact on the Tour Industry

The trend identified in the GAO report is reaffirmed by a survey of tour operators completed last month by the National Tour Association. I would now like to review several of the key findings of that survey:

- Tax-exempt Competition Exists - Eighty-nine percent (89%) of the respondents indicated that their firm encounters competition from tax-exempt organizations. Within this, fifty-seven percent (57%) indicated that the competition is encountered to a very great extent.

- Tax-exempt Competition is a Problem - Tax-exempt competition is viewed as a problem by eighty-nine percent (89%) of the respondents' firms. Fifty-nine percent (59%) indicated that this competition is a problem to a very great extent.

- Tax-exempt Competition Occurs on a Frequent Basis - Forty-six percent (46%) of the respondents report that they have encountered competition since 1981 from eleven (11) or more tax-exempt organizations. Another twenty-two percent (22%) have encountered competition from six to ten (6-10) tax-exempts and twenty-nine percent (29%) from two to five (2-5) tax-exempts.

- Tax-exempt Competition Adversely Affects Profits - Ninety-eight percent (98%) of the respondents reported that their profits had been adversely affected by competition from tax-exempt organizations.

At this point, I must depart from the review of our findings to make an important point of clarification. The GAO report referred to a moment ago included a survey which also asked questions regarding the extent to which tax-exempt competition had been encountered and the extent to which it was a problem. As we reviewed the GAO findings on these questions, it became apparent that an inadequate and inaccurate statistical sampling had been used in that survey as it related to the tour industry.

The National Tour Association conducted its survey as a follow-up to the GAO report, and included three key questions asked by the GAO. The responses to these questions, which numbered almost four times the number of the GAO tour responses, confirmed our earlier concerns. Whereas the GAO report states that fifty-seven percent (57%) of the tour respondents had encountered no tax-exempt competitors, the National Tour Association results reflect that ninety-seven percent (97%) of our tour operators have encountered competition from at least two tax-exempt organizations. Other results previously cited also reflect that tax-exempt competition with tour industry businesses occurs to a much greater extent and is much more of a problem than indicated in the GAO report.

Our point here is not to impugn the GAO report. The error which occurred is understandable. The important point is that our results do reflect an accurate cross-section of the tour industry, and most importantly, they overwhelmingly reflect the seriousness of the problem posed by tax-exempt competition.

Another finding of the National Tour Association survey is that eighty-eight percent (88%) of the respondents report that nonprofits, which offer tours comparable in duration and destination to theirs, offer those tours at lower prices, with those prices on an average being twenty-two (22%) lower than the respondents'. This is an extremely significant finding particularly as it relates to the ability of nonprofits to compete using their various nonprofit privileges to underwrite or offset their cost of operations.

In addition to the contribution that the nonprofit privileges make to this twenty-two percent (22%) differential, we are concerned that inadequate insurance and poorly maintained vehicles may also be part of the reduced cost.

I think the subcommittee members will agree that it is extremely difficult, if not impossible, to compete when your competitor is able to undercut your prices by twenty-two percent (22%).

This seems to be an appropriate juncture to make a very important point. Tour operators do not object to competition. The nature of the work we do -- fulfilling travelers' dreams and needs in a quality fashion, while also making our services economically feasible for those travelers -- requires a combination of creativity and highly refined business skills. Both of these elements are fueled by competition. Therefore, we not only accept competition as a fact of business life, we invite it in recognition of the improvements it brings to our services.

However, we strenuously object to competition which is inherently unfair. Competition in which some competitors are granted certain financial advantages while others are not is simply unfair.

Continuing with the results of our survey, recipients of the survey were asked to respond to a set of situations related to unfair competition. The following are the percentage of respondents who have actually experienced or observed those situations:

95%	Nonprofit offering tour(s) which is the same as or similar to one or more tours offered by your company.
75%	Nonprofit tour promotional material mailed using nonprofit postage rates.
80%	News story (newspaper, radio or television) about a nonprofit's tour(s).
70%	Nonprofit personnel paid with public funds who engage in the development, promotion or operation of group tours.
56%	Nonprofit equipment received with public funds and used in the development, promotion or operation of group tours.
79%	Nonprofit's use of volunteers in the development, promotion or operation of group tours.
84%	A client who would have otherwise selected one of your tours instead of choosing a nonprofit's tour due to the lower price.

If you are beginning to get an impression from these findings that there are a lot of frustrated business people out there, you are absolutely correct.

I would like to read to you excerpts from two unsolicited letters received by the National Tour Association from tour operators.

The first comes from a tour company located in Collinsville, Mississippi:

> As owner of... a fully licensed and insured motorcoach tour operation, I find myself in unfair competition with many churches and club groups in this area who are operating a tax-free tour business... Churches and organized groups began to offer...trips...as a special service to their senior citizens... This service met with such popularity... that it is now out of hand and the number of trips has multiplied like rabbits. Churches have purchased buses and are now offering extended trips, not only to their membership, but to anyone and everyone they can get to complete their bus load.
>
> I attend and support my church and several organizations; but I strongly feel that such groups should not be allowed to take such unfair advantage... Since I pay an enormous tax bill each quarter, I resent helping to subsidize this unfair practice that is hurting my own business. I am ready to register a complaint to someone somewhere.

So that this subcommittee does not get the impression that the unfair competition problem somehow relates only to National Tour Association members, I should point out that this company is not a member of the Association.

The second letter came from a tour company in Hopkins, Michigan:

> I love the business... I believe in what we are doing and we do a good job. All those in my family are involved in the business - we've all worked hard, we don't want our business to die because of this unjust and unfair problem...
>
> ...it's so confusing and frustrating - so unfair and nobody in our government has time to listen, much less 'give a roaring rip' if we die as a profit making company... we are faced with giving up.

This letter had enclosed with it flyers or newsletters from seven (7) different nonprofits promoting tours in the same geographic area.

Mr. Chairman, to this point I hope we have established at least four important facts. First, the growing nonprofit sector is increasingly engaging in commercial activities. Second, those activities are often conducted in competition with for-profit business. Third, the various nonprofit privileges when applied in a competitive situation, result in competition which is fundamentally unfair. And finally, unfair competition is having an adverse impact on businesses, and from our particular perspective, businesses which make up the tour industry.

Unrelated Business Income and Commercial Activities

Due to the multitude of types of nonprofits and the wide range of unfair competitive advantages at their disposal, the effort to return fairness to the marketplace must be conducted on a number of fronts. One of the most important areas in need of attention is that of taxation and the current rules governing unrelated business income.

Mr. Chairman, as you and the subcommittee members well understand, unrelated business taxable income is defined as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less exemptions and allowable deductions. We have no objections to two of the tests of unrelated business activity, i.e. that the activity is a trade or business and that it is regularly carried on.

It is the third factor - that the trade or business must not substantially relate to the organization's exempt purpose or function - which presents extreme problems of interpretation and administration. As stated in the GAO report:

> IRS officials stated that the UBIT is often difficult to administer because of the individual circumstances which must be considered to determine whether an activity is substantially related to an exempt purpose. According to IRS officials, there are no concrete rules for determining the relatedness of income-producing or commercial activity to the exempt purpose of an organization.

The difficulty of applying a relatedness test can be illustrated by our experience in the tour industry. Tax-exempt organizations whose functions are educational in nature tell us that their tours are educational and therefore related. Mr. Chairman, my company has never sold a tour which I did not feel possessed some form of educational value. Charitable or social service organizations can argue that the recreational, socialization, or other intangible values of tours fall within their purposes. Religious organizations also can argue that the fellowship and goodwill engendered by their tours fall within their purposes.

In short, everything is related. It is little wonder in the face of declining profits due to unfair competition, more than one tour operator has noted that they should seek nonprofit status. Usually, they observe that their financial rewards reflect that they are nearing that status, anyway.

There are two important points to be considered with regard to relatedness. Not only is the relatedness test difficult to administer in its present form, it is our view that any attempt to specifically define relatedness will result in difficulties.

In addition to the difficulty of administering any relatedness test, there is a crucial question which cries out for an answer. Why should a trade or business be tax-exempt if it is being carried on by nonprofits and for-profits alike? How can we in all fairness say to a private businessperson that it is right to tax the revenue derived from the sale of his or her product or service, but to tax the revenue a nonprofit derives from the sale of the very same product or service is wrong? Mr. Chairman, in all fairness, I don't think we can say that.

Recommendations

Please consider these responses or possible solutions to the problems we have discussed.

Subcommittee Acknowledgement That a Problem Exists - It is important that the subcommittee in its final report and findings recognize that the problem of unfair competition exists. Such acknowledgement will open the door to a comprehensive review of the entire issue of unfair competition and lead to a series of reforms to return fairness to the marketplace.

Further Investigation - We believe that it is important that there be a more thorough, and yes, more objective understanding of unfair competition than any of us presently possess. We know the problem exists, we know it is adversely affecting a wide range of businesses and industries and we know the problem is especially acute for small businesses; yet, further investigation is warranted.

Clearly, we would not want further study to interrupt or delay actions that should be occurring now, based on what we already know about the issue and its impact on the business community.

Strong Enforcement of Current Laws - As we and the Internal Revenue Service have already indicated, the unrelated business income tax provisions in their current form create difficulties in terms of interpretation and administration. Further, the huge numbers of nonprofits and their increasing commercial activities present enforcement problems. However, these impediments should not be allowed to obscure the fact that a very real need for greater enforcement exists, nor should these difficulties be prohibitive to that enforcement. Tax laws related to for-profit businesses are rigorously enforced. No argument can be mounted to justify any less in regard to nonprofit organizations.

I do want to note that the Internal Revenue Service has announced plans to conduct a three-year review of 3,000 unrelated business income tax forms. These efforts are to be commended, but should be increased and accelerated.

Abolish Relatedness Test of Unrelated Business Activity - Action on the unrelated business income tax is required now. A few moments ago, I reviewed the relatedness factor and explained its inherent problems, both in terms of its current form, as well as any future form it may take. In view of this, we strongly recommend that the relatedness test be abolished.

In its place we are advocating that all revenue from a trade or business regularly carried on by a nonprofit be subject to taxation. We concur with two conditions suggested to this proposal by the Business Coalition For Fair Competition. Those conditions are, first, that the revenue which should be taxed is that which exceeds expenses. Secondly, the revenue should be taxed only if for-profit businesses are providing the same goods or services, i.e. if competition exists.

As stated earlier, the shielding from taxation of the sale of goods or services by a nonprofit is unfair when for-profit businesses are taxed on the sale of the very same goods or services. There is, however, another dimension to this argument. To open many of the previously protected nonprofit activities to taxation will generate significant new revenue for the Federal Government. While the purpose of these hearings is not to seek out new forms of revenue, we feel it is important to note this by-product of our recommended action.

Some may argue that it is somehow unfair or inappropriate to suggest that nonprofits contribute to the Federal tax base. We simply cannot accept this argument. First, our earlier point of fairness applies here as well. Commercial activity is commercial activity -- whether it is conducted by for-profit or nonprofit. Regardless of the sponsor and the beneficiary of the commercial activity, the activity should be taxed.

Second, it is especially unfair that at least some of the vast amount of taxes paid by for-profit businesses are used in many cases to finance the operations of their nonprofit competitors. We are not recommending the reduction of the for-profits' taxes, we are recommending that nonprofits contribute their fair and equitable share along with their for-profit counterparts.

Third, we must recognize that nonprofits are being subsidized either directly or indirectly by the government. Preferred postage rates, exemptions from certain regulations, and direct subsidies all represent our government's financial contributions to nonprofit organizations. To expect that nonprofits repay a portion of this support when it is used to generate profit is not at all unreasonable.

Fourth, an historical rationale for providing tax-exempt status to nonprofit organizations is that the for-profit sector is either unwilling or unable to provide the goods or services provided by nonprofits. Our testimony reflects that this natural marketplace boundary between for-profit and nonprofit activities has encountered substantial erosion. If nonprofits choose to enter the free enterprise arena they should expect to do so under the same rules and conditions followed by the for-profit participants in that arena. One of these rules is taxation of profits.

Finally, our nation is facing an impending crisis. The federal budget deficit looms as a timebomb, the explosion from which may someday wreak havoc within our economy. In view of this and the need for all sectors of the economy to contribute to defusing the deficit timebomb, we believe it is entirely appropriate to ask nonprofits to do their part.

Nonprofit Reserves - Earlier in this testimony, I referred to our concern that some nonprofits are amassing financial reserves at levels far in excess of those required by prudent management practices. This question deserves further study. If, in fact, this is the case, restrictions should be placed on the extent to which such reserves can accummulate. Surplus funds should be applied to the organization's purposes, as opposed to financing the administration of the organization or underwriting further competitive commercial endeavors.

Conclusion

At the beginning of this testimony, I asked that the subcommittee bear in mind one simple question, "what is fair?" We have attempted to accurately describe competition we view as unfair. We have also attempted to offer a set of recommendations which will serve to at least begin righting the wrongs of unfair competition.

In relation to international trade and our trade deficit, we often hear of the need for a level playing field and the desire for all parties to play by the same rules. These conditions have just as much relevance to unfair competition from nonprofits as they do to foreign trade.

America justifiably prides itself with regard to our free enterprise system. The ability of an individual through his or her initiative, drive and determination and entreprenurial spirit to earn an income is a hallmark of our way of life. Inherent in the concept of "free market" is the corresponding concept of "fair market." When a segment of that market finds itself at a disadvantage due to competitive privileges granted to its competitors, we no longer have a fair market and, therefore, we no longer have a free market.

Mr. Chairman, this subcommittee has before it a challenge and an opportunity. The challenge is to sort through the various points and counterpoints you will be hearing during these proceedings and to determine if unfair competition exists. In our view, clearly it does. The opportunity which awaits you is to take important and meaningful steps toward striking a blow for fairness and freedom in America's marketplace.

We are confident that you will meet the challenge and seize the opportunity and we look forward to both.

As I stated at the outset, we are very appreciative of the opportunity to present our views and for your thoughtful consideration of the difficulties we are facing.

Chairman PICKLE. Thank you. Mr. Peterson?

STATEMENT OF ERIC C. PETERSON, VICE PRESIDENT, PUBLIC AFFAIRS, UNITED BUS OWNERS OF AMERICA

Mr. PETERSON. Thank you, Mr. Chairman. My name is Eric Peterson. I am vice president, Public Affairs for United Bus Owners of America. Established in 1971 to represent the needs and interests of bus company management, UBOA today boasts more than 1,600 members throughout the United States and Canada and is dedicated to promoting the safety, integrity, and profitability of motor coach companies, principally those operating as for-profit, taxpaying businesses. You have my testimony so I will move directly to the point and ask that the balance of my statement be entered in the record.

Chairman PICKLE. Without objection, so ordered.

Mr. PETERSON. Mr. Chairman, in my testimony, I cited a number of examples of unfair competition that our members face from universities, from churches, from charitable foundations. These examples are only a few of the many that are encountered by our members throughout the United States, and are instances where nonprofit churches, schools, charitable foundations, and the like, are competing head-to-head with for-profit commercial operators. Because of their special nonprofit status, these tax exempt entities do not face the same cost of operation, the same regulatory burden, or the same tax burden carried by for-profit commercial bus operators.

And there is another advantage bestowed on nonprofit organizations that makes it possible for them to obtain business not available, under law, for for-profit operators. Specifically, I am referring to the numerous grants available through the Urban Mass Transportation Administration, under section 18, section 16(b)(2) and section 6. In all cases, these grants must be made directly to either nonprofit or government chartered organizations and then, at the discretion of those organizations, a private, for-profit operator may be invited to participate. In the case of the 16(b)(2) program, which is designed to provide transportation services for the elderly and the handicapped, little more than one-third of the total actual operators in this program, are for-profit entities.

Making this matter even more difficult for for-profit charter operators to tolerate is the growing number of nonprofit, social service agencies which have been established to provide service under special UMTA transportation programs and are now offering for-hire charter service. In many of these cases, the social service agencies not only do not pay taxes on their commercial charter operations, they are exempt from various State and local registration and permitting requirements which are strictly enforced against for-profit operators travelling the same highways and byways providing the same charter service.

I am sorry to say, Mr. Chairman, that we have no clear idea of just how big the competitive advantage is which is enjoyed by 501(c) organizations which engage in commercial charter and transportation services. We cannot quantify, for the committee, the volume of dollars or the number of business opportunities lost to the nonprofit sector or the cost imposed on the for-profit sector as a consequence of this nonprofit competitive advantage. We can only tell you that virtually every UBOA member can point to at least one example of competition they face from a nonprofit organization and in each of these examples, they can demonstrate some advantage which the nonprofit enjoys as a result of their special standing under section 501(c).

Mr. Chairman, the passenger ground transportation industry is a very financially fragile entity. The for-profit sector of the industry is generating barely 2 percent profit while the nonprofit and government sectors are heavily subsidized in order to survive. From the perspective of the for-profit sector of this industry, and especially recognizing its beleaguered state, it would be far preferable that nonprofit organizations, be they churches, schools, social service agencies, or whatever, simply refrain from offering commercial transportation service, providing only those basic transportation services essential to their clientele.

But if these nonprofits will not refrain, then they at least should be required to meet all the taxation, regulatory and operational burdens imposed on for-profit operators.

They should not be allowed to hide behind the protective mantle of section 501(c) to avoid the regulatory requirements demanded of others.

On behalf of its more than 1,600 bus owner members, UBOA urges that Congress take immediate and direct steps to improve enforcement of the unrelated business income tax provisions of the IRS Code.

Additionally, Congress should make clear that granting of nonprofit status under the Tax Code is not a waiver of other legal requirements imposed on for-profit entities engaged in the same line of business.

Finally, Congress should make clear, through whatever means necessary, that granting of nonprofit status upon some should not impair the profitability of others.

After all, Mr. Chairman, without profits, who is going to pay the taxes and make the contributions that enable both Government and the nonprofit sector to function?

[The statement of Mr. Peterson follows:]

Statement of the United Bus Owners of America

INTRODUCTION

Mr. Chairman, members of the committee, my name is Eric C. Peterson, I am vice president, public affairs for United Bus Owners of America (UBOA). Established in 1971 to represent the needs and interests of bus company management, UBOA today boasts more than 1,600 members throughout the United States and Canada, and is dedicated to promoting the safety, integrity and profitability of motor coach companies, principally those operating as for-profit, taxpaying businesses.

My purpose in coming before the committee today is to bring to this body's attention the effect competition from tax-exempt, non-profit bus operations has on UBOA's for-profit motor coach operators, and to demonstrate to this committee the special status many of these tax-exempt bus operations enjoy in the regulatory arena as a result of their non-profit status.

INDUSTRY OVERVIEW

Mr. Chairman, UBOA's members are engaged in charter, regular route, special operations and transit services. They are classified by the Interstate Commerce Commission (ICC) as class I, II, and III interstate passenger motor carriers and as intrastate passenger motor carriers by their respective states. According to the best estimates of the ICC, there are approximately 2,400 to 3,000 of these carriers, operating 25,000 motor coaches, and employing more than 44,000 persons. In 1985, the industry generated gross revenue of nearly $2 billion and net revenue of only $65 million. The industry's operating ratio is approximately 98 percent.

THE EVOLUTION OF NON-PROFIT COMPETITION

Since its haydays in the 1950's and 60's, the motor coach industry has faced stiff, toll-taking competition from numerous sectors of our nation's economy. With the enactment of the Urban Mass Transportation Act of 1964, virtually all public transit service was assumed by local government agencies with substantial subsidy provided by the federal and state governments. Federal subsidy for the rail passenger industry beginning in the late 1960's was the next competitive hit against the motor coach industry.

During the 1970's UMTA continued its march against for-profit motor passenger carriers with the establishment of public transportation programs that specifically called for the use of non-profit organizations as providers. An example of this non-profit mandate can be found in the 16(b)(2) elderly and handicapped transportation program.

More recently, airline deregulation, trucking deregulation and the growing trend among military installations to purchase their own fleets of motor coaches rather than hire private operators have all taken their toll on the American motor coach industry.

And throughout this entire period, the industry has witnessed a rise in the number of non-profit organizations such as churches and universities which have purchased their own vehicles, ostensibly for the purpose of providing transportation for church functions, or student commuter services around campus, only to discover these vehicles being offered for hire in the commercial charter market.

SOME CURRENT EXAMPLES

Allow me, Mr. Chairman, to site a few examples of the non-profit competition UBOA members face.

In Flint, Michigan, the Antioch Missionary Baptist Church operates Roadway Charter and Tours. The company is a commercial charter service with ICC authority and is operated out of the church's office. Because of the church's non-profit status, Roadway pays no federal, state, or local taxes. In addition, prior to recent changes in the Social Security laws, the company paid no Social Security taxes for its drivers, claiming them as church employees. Advertising directly above Roadway Charter and Tours in the Flint, Michigan phone book is Michigan Trailways, which by contrast, must pay significant local, state and federal income taxes, workmen's compensation, unemployment, and Social Security taxes, and yet for competitive reasons can not charge significantly more for the same service offered by the tax-exempt charter bus operations of the Antioch Missionary Baptist Church.

Ferris State College in Big Rapids, Michigan operates a 47 passenger motor coach, purchased primarily to provide transportation for the school's athletic teams. Ferris State, however, regularly uses its bus in commercial charter and tour service at prices competitive with other for-profit operators. In addition to being exempt from safety and other economic regulatory considerations because of its status as a non-profit state chartered school, the bus operation pays no taxes on the revenue generated from its charter service.

St. Peter's Rock Baptist Church of Little Rock, Arkansas operates a 47 passenger Eagle Coach with church license plates in charter and special operations. In addition to paying no taxes on this commercial activity, the church is not required to comply with Arkansas State commercial bus operating and permitting requirments, and is not registered with the ICC for interstate operations.

In Colorado Springs, Colorado, the El Pomar Foundation, a non-profit charitable foundation chartered under Section 501(c) of the Internal Revenue Code, operates the Broadmoor Hotel which in turn operates a fleet of charter motor coaches including two new $400,000 West German built Setras. Because of its special relationship with the El Pomar Foundation, the Broadmoor was able recently to request and obtain from the state of Colorado a waiver of the state's charter bus insurance requirement. The waiver authorized self-insurance for the Broadmoor's charter fleet for the first one million dollars of liability. Comparable for-profit operators pay approximately $6,000 per year, per bus for the first $1 million and $1,000 per year, per bus for the additional $4 million in liability insurance required by the ICC and the state of Colorado. As a result, the Broadmoor's charter bus services now hold, at minimum, a $6,000 per bus, per year advantage over any other for-profit charter bus operator in the market.

THE NON-PROFIT ADVANTAGE

Mr. Chairman, these are only a few of the examples provided UBOA by its members from throughout the United States of instances where non-profit churches, schools, charitable foundations, and the like are competing head-to-head with for-profit commercial operators. Because of their special non-profit status these tax exempt entities do not face the same cost of operation, the same regulatory burden, or the same tax burden carried by the for-profit commercial charter bus operator.

And there is another advantage bestowed on non-profit organizations that makes it possible for them to obtain business not available by law to for-profit operators. Specifically, I am referring to the numerous grants available through the Urban Mass Transportation Administration under sections 18, 16(b)(2), and 6. In all cases, these grants must be made directly to either non-profit or government chartered organizations, and then at the discretion of those organizations, a private, for-profit operator may be invited to participate. In the case of the 16(b)(2) program which is designed to provide transportation services for the elderly and handicapped, little more than one-third of the total actual operators in the program are for-profit entitites.

Making this matter even more difficult for for-profit charter operators to tolerate is the growing number of non-profit social service agencies which have been established to provide services under special UMTA transportation programs and are now offering for-hire charter service. In many of these cases, the social service agencies not only do not pay taxes on their commercial charter operations, they are exempt from various state and local registration and permitting requirements which are strictly enforced against for-profit operators traveling the same highways and biways, providing the same charter service.

SUMMARY AND RECOMMENDATIONS

I am sorry to say Mr. Chairman that we have no clear idea of just how big the competitive advantage is which is enjoyed by those 501(c) organizations which engage in commercial charter and transportation services. We can not quantify for the committee the volume of dollars, or number of business opportunities lost to the non-profit sector, or the cost imposed on the for-profit sector as a consequence of this non-profit competitive advantage. We can only tell you that virtually every UBOA member can point to at least one example of competition they face from a non-profit organization. And in each of these examples they can demonstrate some advantage which the non-profit enjoys as a result of their special standing under Section 501(c).

Mr. Chairman, the passenger ground transportation industry is a very financially fragile entity. As I noted earlier, the for-profit sector of the industry is generating barely 2 percent profit. The non-profit and government sectors are heavily subsidized in order to survive.

From the perspective of the for-profit sector of this industry, and especially recognizing its beleaguered state, it would be far preferrable that non-profit organizations, be they churches, schools, social service agencies, or the like, simply refrain from offering commercial transportation service, providing only those basic transportation services essential to their clientele.

But if these non-profits will not refrain, then they at least should be required to meet all the taxation, regulatory and operational burdens imposed on for-profit operators. They should not be allowed to hide behind the protective mantle of Section 501(c) to avoid the requirements demanded of others.

In behalf of its more than 1,600 bus owner members, UBOA urges that Congress take immediate and direct steps to improve enforcement of the unrelated business income tax provisions of the IRS code. Additionally, Congress should make clear that the granting of non-profit status under the tax code is not a waiver of other legal requirements imposed on for-profit entities engaged in the same line of business.

Finally, Congress should make clear, through whatever means necessary, that the granting of non-profit status upon some should not impair the profitability of others. After all, Mr. Chairman, without profits, who is going to pay the taxes and make the contributions that enable both government and the non-profit sector to function?

Chairman Pickle. Thank you, Mr. Peterson. And now, Miss Perry.

STATEMENT OF SUSAN PERRY, VICE PRESIDENT, CONGRESSIONAL AFFAIRS, AMERICAN BUS ASSOCIATION

Ms. Perry. Thank you, Mr. Chairman, members of the subcommittee. I appreciate this opportunity to summarize the testimony that has already been submitted on behalf of the American Bus Association.

My name is Susan Perry. I am vice president, congressional affairs, of the association.

We have a membership of some 3,500, including bus owners and operators, as well as others engaged in travel and tourism. We are here today to express our view that the bus tour and charter activities of tax-exempt organizations constitute unfair competition.

It is unfair for two reasons. One, because these entities enjoy tax and other advantages unavailable to tax-paying bus companies, and two, because these organizations are exempt from many Federal and State safety regulations that apply to private bus operators.

The size of the subsidized charter and tour industry is impressive. Data gathered from Federal Highway Administration sources indicate that in 1985, there was a total U.S. bus fleet of 594,000. Of this total, only 25,000 were commercial intercity buses; 158,000 were supposedly not for hire, privately owned, non-commercial buses.

A review of Highway Administration data, and industry sources, indicate that between 25 and 50 percent of these buses operated in interstate commerce at least once a year. Thus, somewhere around 60,000 of them offer direct competition to the 25,000 buses operated by private sector commercial operators.

The ABA members indicate that this competition is primarily from tax-exempt church and school groups who offer tours and charters. The ABA submits that these groups engage in income-producing activities that could be provided by taxable bus companies.

In fact, but for the unfair intrusion into the tax-paying bus companies' market by tax-exempt organizations, such services would indeed by supplied by tax-paying bus companies.

Additionally, ABA submits that when these organizations compete with tax-paying commercial bus companies, and the Government is deprived of tax revenues, the income-producing activities of these exempt organizations are in direct conflict with Federal deficit reduction policies.

While the ABA believes that the present rules interpreting the unrelated business income tax law do in fact permit unfair competition, the problem we think is primarily one of enforcement. We propose that this subcommittee, in some form, recommend the commercial tour and charter activities of tax-exempt organizations be subject to the unrelated business income tax.

Finally, we submit that revisions should be made to the current forms 990 and 990-T. Tax-exempt organizations should be required to report all commercial and charter activity on form 990-T.

Mr. Chairman, in conclusion, let me share an observation with you regarding our industry. Bus companies now are faced with competition from the private automobile, from Amtrak, and from airlines with discount fares.

Many of the companies are in precarious financial condition. Competition that these companies face from school and church charter activities is yet another in the list of difficulties that these companies experience.

Proper enforcement of the tax law and taxation of this tax-exempt tour and charter income by the Internal Revenue Service would be a major step toward assuring the financial stability of these carriers.

On behalf of the members of ABA, I wish to thank you for the opportunity to testify, and I will be happy to try to respond to any questions that yon may have. Thank you.

[The statement of Ms. Perry follows:]

STATEMENT OF THE
AMERICAN BUS ASSOCIATION
SUSAN PERRY, VICE PRESIDENT OF CONGRESSIONAL AFFAIRS
BEFORE THE HOUSE WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
CONCERNING THE UNRELATED BUSINESS INCOME TAX

JUNE 25, 1987

My name is Susan Perry, and I am Vice President of Congressional Affairs for the American Bus Association ("ABA" or "the Association"). The ABA represents more than 3,500 companies involved with bus regular route, tour and charter, and airport and commuter services, and in businesses that are related to travel and tourism.

During the past few years, ABA members have faced increasing competition from and lost business to tax-exempt schools, colleges, universities, churches and other groups that provide bus tour and charter service. As tax-exempt organizations, these entities enjoy tax and other advantages unavailable to tax-paying bus companies. ABA submits that when Congressional policy confers tax or other advantages on tax-paying bus companies' competitors, those bus companies cannot compete as effectively. That advantage constitutes unfair competition.

As an initial matter, ABA would like to explain to the Subcommittee the manner by which tax-exempt organizations have entered the taxpaying bus companies' market and why the revenues earned by such commercial activity is taxable as unrelated business income. Traditionally, schools, colleges, and churches have provided transportation for students and church-members. In either case, the tax-exempt entity had some relationship with the passengers, whether they were degree-seeking students or church members, and the transportation provided was in furtherance of the tax-exempt organization's religious or educational functions. However, many of these tax-exempt entities are now providing tour and charter services to the general public or to tour groups - the traditional market of tax-paying, commercial charter bus companies. Churches and schools obtain this business by promoting their charter and tour business to groups outside the school or church. These churches and schools are able to offer substantially discounted fares because of their tax-exempt status and frequently offer charter service in exchange for "donations" from passengers.

I appear here today to express ABA's view that such commercial activity on the part of tax-exempt schools and churches constitutes unfair competition. The competition engaged in by tax-exempt organizations is unfair because: (1) such organizations do not pay federal, state, or local taxes and (2) such entities are exempt from many federal and state safety regulations that apply to private operators. ABA submits that when tax-exempt schools and churches engage in tour and charter activity, they not only threaten the tax-paying bus industry, but also deprive the state and Federal government of substantial tax revenues, revenues to which the government is entitled and which it would otherwise receive from tax-paying bus companies.

ABA is aware of numerous schools and churches that are engaging in and promoting tour and charter activities. As many charter operators are small businesses, unfair competition from tax-exempt entities, together with other financial pressures, such as the high cost of liability insurance, is threatening the existence of many of these businesses. It should be noted that tax-exempt organizations are not required to carry the $5 million liability insurance that is required of tax-paying bus operators.

The size of the subsidized charter and tour industry is impressive. Data gathered from Federal Highway Administration ("FHWA") sources indicate that in 1985 there was a total U.S. bus fleet of 594,000. Of this total, only 25,000 were commercial intercity buses. Roughly 323,000 were publicly owned school buses; 158,000 were privately owned, non-commercial buses and 62,000 were publicly owned transit buses. Thus, the total of non profit buses that can be used in charter service in competition with the privately owned commercial buses is 543,000 buses, roughly 20 times the size of the privately owned, commercial bus fleet.

With regard to subsidized public sector competition, this problem has been addressed effectively through regulation. The Urban Mass Transit Authority ("UMTA") has just promulgated a regulation which essentially prohibits federally funded buses and facilities from being used for charter service.* Similar effective action is needed with regard to private bus operators.

The 158,000 privately owned, non-commercial buses represent a major, subsidized source of charter service that has not been addressed. A review of FHWA data and industry sources indicate that between 25 and 50 percent of these buses are operated in interstate commerce at least once a year. Thus, somewhere around 60,000 of these buses offer direct competition to the 25,000 buses operated by private sector commercial operators.

If the Subcommittee feels such information would be useful, ABA stands willing to help the Subcommittee develop a comprehensive list of tax-exempt organizations engaged in provision of bus tour and charter services. For the moment, however, let me simply recite three of the many examples of this type of conduct.

- One ABA member reports that a small Western city operates a school bus which is used for every conceivable purpose. The bus generates only $3,600 in revenues annually. A for profit motor carrier could not operate on such a basis. Yet, this tax-exempt organization has caused for-profit bus companies to lose business.

- Another member reports that its charter rate has dropped about 70% in areas in which a senior citizens' center advertises charters. Although the bus service originally provided transportation for senior citizens on trips to the doctor or shopping, this member reports that the center has expanded its area to 150 miles to take in tour events, such as stage plays.

- Another member reports that a number of churches in his area operate tours on a "donation" basis. One church owns a fleet of modern tour buses. This member expresses concerns with the safety of the church buses which are not inspected by state regulatory authorities.

For purposes of the Subcommittee's inquiry, the first issue that must be addressed is whether, in fact, the income derived from the bus tour and charter activities of tax-exempt organizations constitutes unrelated business income. The Association believes that existing law requires that the income derived from this type of tour and charter service be taxed as unrelated business income.

---

* Urban Mass Transit Authority - Docket 82-1, Charter Service, 52 Fed. Reg. 1191-6, April 13, 1987.

As an initial matter, it should be noted that the tax law provisions governing the treatment of income of tax-exempt organizations have changed over the years. In 1924, the Supreme Court decided that for purposes of tax exemption, the source of income of an non-profit organization was not the key issue; what was important was the destination of the income. Trinidad v. Sagrada Order de Precadores, 263 U.S. 578 (1924). This provision allowed tax-exempt organizations to generate income from any source, including the acquisition of profit-making businesses, if the net profits were devoted to activities that were recognized as exempt. The destination of income test was abandoned in 1950, when Congress adopted the unrelated business income tax. A three part test was established: a tax-exempt organization is taxable if the income-producing activity is: (1) a trade or business; (2) regularly carried on; (3) not substantially related to the organization's performance of its exempt function. The unrelated business income tax was enacted in response to perceived abuses of tax laws by tax-exempt organizations that engaged in profit making activities. Congress discerned a need to restrain unfair competition fostered by the "destination of income" test.

Under the first two criteria applicable to determine whether income is unrelated business income, it is clear that the conduct of charter and tour activities by tax-exempt organizations constitutes a "trade or business" regularly carried on. It cannot be denied that a tax-exempt organization's provision of tour and charter services constitutes a trade or business. The Treasury regulations at section 1.513-1(b) define trade or business as "any activity carried on for the production of income from the sale of goods or performance of services." The fact that a tax-exempt school or church provides a similar service in a manner consistent with the organization's tax-exempt purpose does not mean that the service, if provided in a different context, is not a trade or business. The provision of commercial tour and charter services is a trade or business.

The charter business, as it is carried on by schools and churches, is "regularly carried on." In this regard the Internal Revenue Service looks at the frequency and continuity with which the income-producing activity is conducted; and whether the activity is "pursued in a manner" that is generally similar to comparable commercial activities. Exempt-organization tour and charter activities meet both these criteria. The activity is systematically and continuously carried on and the exempt organizations pursue the activity in precisely the same manner as ABA members pursue it.

Under the third prong of the test, the trade or business must have a substantial causal connection to the achievement of the exempt purpose of the organization in order to be tax-exempt. Although the Internal Revenue Service has not ruled extensively on the provision of bus tour and charter services by non-profit organizations, in Rev. Rul. 77-246, 1977-2 C.B. 190, the Service indicated that a non-profit organization that provides, upon request, low-cost bus transportation to senior citizens and handicapped persons in a community where public transportation is unavailable or inadequate qualifies for exemption under section 501(c)(3) of the Code and is operated exclusively for a charitable purpose.

The stated purpose of the organization in Rev. Rul. 77-246 is to provide low cost transportation services to senior citizens and handicapped persons of a particular community. The organization owned and operated a bus which made daily trips to transport senior citizens and handicapped persons to downtown shopping areas and medical facilities. Commercial transportation was otherwise unavailable or inadequate for these members of the community who were required to show proof of age or handicap. It should be noted that this revenue ruling describes a non-profit organization that provides the elderly and handicapped with necessary transportation within the community and that this is an activity directed toward meeting the special needs of this charitable class of individuals. This non-profit organization is providing relief to the distressed, a charitable purpose.

The ABA submits that, while the Internal Revenue Service has determined that a transportation service, as described above, is operating in furtherance of a charitable purpose, the tour and charter activities of schools and churches is a trade or business that is unrelated to the organizations' charitable purposes. Schools and churches provide transportation in areas where for-profit bus companies are currently operating or where they are able to provide services (See Rev. Rul. 78-68, 1978-1 C.B. 149; Rev. Rul. 78-69, 1978-1 C.B. 156). Schools and churches are not granted an exemption to provide transportation services to individuals who have no relationship to the exempt organization.

In conclusion, because the tour and charter activity meets all three criteria of unrelated business activity, all income generated by it must be taxed as unrelated business income.

Thus, in response to the Subcommittee's inquiry: "To what extent do tax-exempt organizations engage in income-producing activities that are being, or could be carried on, by taxable businesses?", the answer is apparent. Not only could the business being conducted by tax-exempt organizations be carried by taxable businesses, it in fact is carried on by such businesses. In fact, but for the unfair intrusion into the tax-paying bus company's market by tax-exempt churches and schools, such services would continue to be supplied by tax-paying bus companies.

While the foregoing analysis dictates that the income derived from a tax-exempt organization's tour and charter service be declared as unrelated business income, public policy warrants the same conclusion. Because tax-exempt organizations are supported by tax deductible donations, are exempt from federal, state and local taxes, it is the taxpayer that pays for the service. Thus, in response to the Subcommittee's questions "To what extent, if any, do current income-producing activities of exempt organizations relate to federal budget cuts or other government policies?", ABA replies as follows. When tax-exempt organizations compete with tax-paying commercial entities and the government is thereby deprived of tax revenues, the income-producing activities of exempt organizations are in direct conflict with federal deficit reduction policies.

The Subcommittee has asked as well, "Do the present law rules permit unfair competition by exempt organizations? If so, how should the rules be changed?" As I believe my testimony has made clear, ABA believes that the present law and regulations, as interpreted and enforced, do in fact permit unfair competition. ABA proposes that the Subcommittee provide, through report language or otherwise, that commercial tour and charter activities of tax-exempt organizations are subject to the unrelated business income tax as they are not related to the charitable purpose of the tax-exempt organizations.

ABA also submits that the current forms 990 and 990T are not adequate to identify compliance issues. ABA suggests that tax-exempt organizations be required to report all commercial tour and charter activity on form 990T. Finally, ABA suggests that Internal Revenue Service enforcement be emphasized so that tax-exempt organizations that either do not report or mischaracterize their unrelated business income could be readily identified, thus enabling the IRS to take appropriate action.

On behalf of the ABA, I would like to thank the Subcommittee for the opportunity to testify on this important issue.

Chairman **Pickle**. Thank you, Miss Perry.

I would like to thank all the panelists for your testimony. I can see that you would feel that your business is maybe more singularly affected by this problem than a lot of other businesses, and I think that your testimony has been well to the point. That is, you have given us examples of specifically how it has affected you, and this is the type of information we want.

Let me ask a few of you questions, just in general. Mr. Guenther, I guess, you showed us an ad, one column——

Mr. **Guenther**. Paid advertising.

Chairman **Pickle**. And the other nonprofit. Two-thirds of the page would be showing nonprofits. Do you know whether any of the nonprofit groups paid any kind of UBIT taxes?

Mr. **Guenther**. I have no way of knowing that, Mr. Chairman.

Chairman **Pickle**. You assume that they did not?

Mr. **Guenther**. I could not make that assumption, Mr. Chairman. I just do not know. I have no way of knowing.

Chairman **Pickle**. Well, I think it would be reasonable that very few of them, if any. And you others have given me similar examples. Mr. Peterson, you mentioned your bussing out.

Suppose a church in Oklahoma City wanted to just organize a tour of its citizens to go to Philadelphia to see the signing of the Constitution ceremony next week, and they raised their hands in the congregation after being asked who wants to go, and signed up at the office.

And they rent a bus or provide a bus, and so forth, and they go on this tour. Would that be objectionable to you?

Mr. **Peterson**. Well, Mr. Chairman, the objection would come, for example, if they used the church bus which was licensed, probably, in Oklahoma, with a church license plate, and therefore was exempt from both the requirements of the Interstate Commerce Commission with regard to interstate commercial activity, and to a large extent, from the safety standards imposed by the State of Oklahoma on commercial operators.

So those are the threshold concerns. Then, you talked earlier about the halo effect. There was a question in one of the earlier panels about the halo effect.

It is that halo effect which has an additional impact. By using the church bus for that ostensibly commercial charter activity—that is, selling a service to the members of the congregation—they are depriving a commercial operator of the opportunity to engage in commerce and to——

Chairman **Pickle**. Well, if we take the position you do, it is possible, then, that we would say to all churches in the United States, you cannot organize a tour group unless you work through a private bus company, bus association. Now that would be a pretty strong position to take, and I think that both the churches, and the Government, and the Lord would be on top of it if——[Laughter.]

Mr. **Peterson**. Mr. Chairman, we have no objection to their engaging in an activity, but the point is, that if they are going to engage in that activity they need to comply with the regulations and requirements that the commercial operators do.

Chairman **Pickle**. I noticed that was a point you made, that if they did go on a tour, that they ought to be subject to taxation rates, to regulatory concerns such as safety, and with operational requirements.

And if they did that, that would be more satisfactory. Suppose they did pay UBIT taxes. Would that satisfy you?

Mr. **Peterson**. Well, on that issue, yes.

Chairman **Pickle**. If they paid their UBI taxes, and if they complied with these taxation, regulatory, and operational requirements, then you could not really have an objection, could you?

Mr. **Perry**. That is right.

Mr. **Peterson**. That is right.

Chairman **Pickle**. All right. Now if a church had an operation where they had a tour office that has been legally established, and they operate tours, they sprinkled a little holy water and said we have been ordained to run bus tours, you would object to that because that would be in the business, officially.

But if they were set up and ordained, so to speak, if they met the TRO, taxation, regulatory and operational requirements, and paid their taxes, you would have to say that would not be particularly unfair competition.

But as it is now, with two-thirds of them, or most of them organized for special groups, we—I have to assume they do not pay UBIT taxes, and I have serious concerns when I hear that the city of El Paso, for instance, is just running trips as a business, and I do not know whether they are paying tax or not. I would assume they would not, but I do not know that, either.

Ms. **Causey**. I do not know either, Mr. Chairman.

Chairman **Pickle**. Well, I see your problem, and I do not know what we can do about it, but I think yours is a rather clear-cut case, and I am glad to get your testimony. Thank you.

Mr. Schulze.

Mr. **Schulze**. Thank you, Mr. Chairman.

Is it the church which organizes this bus tour once a year that is of concern, or is it being done more often than that, on a regular basis?

Ms. **Causey**. It is being done, from all indications that we have, a lot more often than that, and what happens——

Mr. **Schulze**. So a once a year tour is not what we are talking about?

Ms. **Causey**. No, the once a year tour is not what we are talking about, but the once a year tour would be the exception anyway.

Mr. **Schulze**. It would.

Ms. **Causey**. And they are not just organizing tours and taking them "of their own flock", as it were, which would be somewhat related, although certainly not related to the purpose and mission of the church, but they are making the bus available, if they own a bus, to other people as well.

You or I could go to them and say we have a group of 40 people and we would like to use your bus, and they say fine. Now, technically, there is no charge, but a donation would be nice.

Mr. **Schulze**. The New Jersey case you cited, Mr. Guenther, is, as you stated, somewhat out of the jurisdiction, at least of this committee, but is a fairly shocking example of how this can be carried to an ultimate extreme.

I find it difficult to believe that you could successfully compete with that kind of a competitor, and the prices show that. The comparison prices show that it is difficult, if not impossible, to compete with that kind of competition.

Do you have any idea what happens to the revenue in those instances? Does that accrue to the State? And the next question is, do you have any idea how much those people who are running it are being compensated?

Are they becoming compensated just as another State employee, or are there bonuses, or additional salaries that are involved with that?

Mr. GUENTHER. I do not know what disposition is made of the profits generated by New Jersey Transit's tours. I do not know whether it goes into the general revenues of the State, or whether it is retained by New Jersey Transit for their own use. I do not know that.

I do not know the salary, bonus, or other situation with regard to their employees.

Mr. SCHULZE. How about where travel agencies are set up in the nonprofits? Is anyone on the panel aware of compensation in those instances? Is it comparable to the private sector, or, is it lower?

Mr. GUENTHER. In many cases, volunteers—as has been pointed out—volunteers are used, particularly for senior citizen centers. Volunteers are the tour planners, and the modus operandi is not very mysterious. They can say, get my brochure and see my trip to eastern Canada, or, to Cape Cod, or to Niagara Falls, and see what hotels we use, and see where we stop for sightseeing, and where we stop for restaurants. And they can get on the phone and call those places, and say, here we are, the "ABC Center," and we want to come, and they get their price quotations, and they charter their motor coach and away they go.

Very simple to do, and obviously, the cost of it, up front, can be less expensive. I have got overhead, I have got to advertise, I have got to pay for these ads in the paper, and then I have got to pay taxes. So I cannot compete with those kinds of tours.

Mr. SCHULZE. Ms. Causey?

Ms. CAUSEY. Yes. Back to the religious part of it, I have some brochures here from various religious groups. I really cannot quite understand what a "Grand Alaska Adventure" has to do with a church organization, but that is one of the tours that is offered on this. There are several others here.

There is one from the Christian Cruise Vacations from Robert Schuler Ministries in Garden Grove, California, that specifically states down here that these cruises are not available through travel agents. So he is doing his own thing there, and has to be compensated for it.

Mr. SCHULZE. I understand that radio stations, from time to time will do the same kind of a promotion with tours. Do they do that on a profitmaking basis?

Mr. GUENTHER. Usually, that is done in consort with a travel agency or a tour operator, and there is an obvious tradeoff that the star of the show gets—he and his wife get to go along, and that is a draw for other people to join the tour, and the tour company pays for them in return for the radio time that they get as part of the promotion of the overall program. Yes.

Mr. **Schulze**. You are not aware of whether that, then, is declared as income?

Mr. **Guenther**. That is known as "barter advertising" and that is a tradeoff kind of a situation.

Mr. **Schulze**. I thank the panel. It has been very interesting and informative, and I appreciate your taking time to be with us today.

Chairman **Pickle**. I thank the panel, too, and we appreciate your patience during these roll calls. Thank you very much.

Ms. **Causey**. Mr. Chairman, I did bring along a bunch of brochures that I would like to leave to be entered into the record.

Chairman **Pickle**. Are these advertisements for tours that you are asking us to take?

Ms. **Causey**. No, sir. I hope not. [Laughter.]

Chairman **Pickel**. We will be glad to have them. Thank you.

[The material follows:]

Indiana University Alumni Association
AREA CODE 812/335-1711

INDIANA MEMORIAL UNION/M-17/BLOOMINGTON, INDIANA 47405

Dear Alumni:

In our continuing search for truly outstanding educational travel values, we are pleased to offer a Golden Autumn Cruise from New York to New England, up the St. Lawrence River, and the Maritime Provinces of Canada. Here is an opportunity to see the Statue of Liberty reborn and enjoy a North American cruise.

All this and the Royal Odyssey. The largest ship of Royal Cruise Line allows you to enjoy its spaciousness, its warm and friendly atmosphere, its superb Continental Cuisine and full array of shipboard activities.

Of course, our space is limited, so please make your reservation early so you won't be disappointed later.

Sincerely,

Frank B. Jones

Frank B. Jones
Executive Director
Indiana University
Alumni Association

P.S. We also can offer you a unique opportunity to start on this cruise in England, enjoy 7 more days on the Royal Odyssey at a great savings. Fly to London and board the ship for the Great Transatlantic Crossing! Enjoy either two or four nights in London before sailing to New York. The "repositioning" of the ship results in lower rates.

Winner of fourteen national Alumni Administration awards for comprehensive excellence in alumni programming

Golden Autumn on the *Royal Odyssey*
Official Reservation Form

Send to: **IUAA Educational Tours**
IMU M-17
Bloomington, IN 47405

Please make ____ reservation(s)

(legal name as it appears on passport)

Mr.
Mrs.
Miss
Name ______________________________ Class Year __________
(First) *(Middle)* *(Last)*

Mr.
Mrs.
Miss
Name ______________________________ Class Year __________
(First) *(Middle)* *(Last)*

Address ______________________________

City ______________________________ St. ________ Zip __________

Telephone Numbers — Home (______) ______________ Office (______) ______________

1st choice: Category ______ Stateroom for _____ persons. **2nd choice:** Category ______ Stateroom for _____ persons.

☐ I prefer single accommodations. ☐ I am reserving as a single but wish to share accommodations if arrangements can be made.

☐ SMOKING *or* ☐ NON-SMOKING **(See Reverse Side)**

[redacted]

I *(we)* prefer **main** (6:45 p.m.) ☐ or **late** (8:30 p.m.) ☐ seating at dinner.

Please seat me *(us)* at a table for 4 6 8 *(circle one)* with ______________________________

____
(names)

Departure City ☐ Indianapolis— Other Departure City ______________________________

☐ I *(we)* will be taking the 8 day cruise. (Golden Autumn)
☐ I *(we)* will be taking the 17 day cruise. (Golden Autumn & Transatlantic)
☐ I *(we)* have previously sailed with Royal Cruise Line.

Enclosed is my deposit of $ ______________ (**$400.00** *per person required)*

☐ *Accept my check made payable to:* **Royal Cruise Line** *or* ☐ Charge the deposit to
☐ MASTERCARD ☐ VISA or ☐ CROWN CARD

Card # ______________ Expires ______________ / ______________
(signature as it appears on your credit card)

Final payment due 60 days prior to departure.

For more information, call Rose Gulliver at the IU Desk of Royal Cruise Line
Toll free (800) 227-4534 or (800) 792-2992 *(Ca. only)*

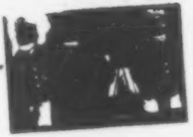
[redacted]

The Indiana University Alumni Association
Invites You To Join This Special Sailing
September 8, 1986

GOLDEN AUTUMN CRUISE
CANADA
MARITIME PROVINCES

ABOARD THE ELEGANT ROYAL ODYSSEY

INAUGURAL SEASON
Royal Cruise Line
INDIANA UNIVERSITY ALUMNI ASSOCIATION
1854



Cover: The famed Chateau Frontenac in Quebec.
Right: Hand-carved figurines like these are available in many of your ports.

From the Glorious U.S. to Golden Canada!

For a hundred years, the Statue of Liberty has welcomed the world's sailing and steam ships to New York Harbor. This year, the *Royal Odyssey* joins in celebrating the Great Lady's Centennial with an inaugural series of spectacular cruises exploring historic New England and Canada's unique Maritime Provinces.

Your cruise begins by saluting her famous torch with a special shipboard "toast," and along the way you'll call at the great cities of the Atlantic seaboard as well as the colorful, traditional ports that dot the Northeast Coast.

Experience the charm of Canada's European atmosphere, the quaint delights of New England, the rugged whaling-days memories of the Maritime Provinces and the great St. Lawrence. It's the Golden Autumn cruise aboard the elegant *Royal Odyssey* – as magnificent and colorful as the northeast's fabulous fall foliage itself.

Your elegant *Royal Odyssey*. While your gyroscopically stabilized *Royal Odyssey* glides across the blue waters of the northeast, you'll savor the special pleasures of "Life on an Odyssey." Your own Cabin and Dining Room Stewards, 24-hour Room Service, spacious staterooms, fine European linen, gleaming silver and superb Royal Doulton china, outstanding entertainment, gallant dancing partners, and the relaxed style of shipboard living that is unique to our line.

Dazzling days and nights. Your time between ports can be enjoyed however you choose: a variety of deck and indoor games, a refreshing dip in the pool, exercise, sauna, massage. All are yours to enjoy. Evening arrives and there's music, dancing, Gala Dinners, first-run movies, musical revues and Costume Balls. Fantastic!

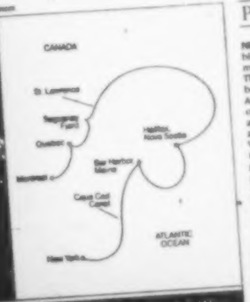
Dining out every day. Our European master chefs prepare a variety of superb cuisine that caters to American tastes, ***plus new for 1986, special entrees that comply with the American Heart Association's dietary recommendations to reduce salt, fat and cholesterol (see inset).*** From Continental or full-course breakfasts, to colorful luncheon buffets, to thrilling a la carte dinners – we believe our cuisine is the finest afloat!

The American Heart Association and Royal Cruise Line present An Exclusive First in Cruising!

Maintaining its role as innovator in the cruise industry, Royal Cruise Line is the *first cruise line* to include selected entrees specifically prepared in accordance with the dietary recommendations of the American Heart Association. These savory new menu items are now available at all breakfasts, lunches and dinners aboard our ships. Look for the specially identified American Heart Association selections on every menu and "Dine to Your Heart's Content."

Life on an Odyssey – relaxed and friendly, yet with its unsurpassed luxury

The winding ship-line on to New England and the Maritime Provinces



GLITTERING HIGHLIGHTS

RCL Loves NYC
It's still the Big Apple – the biggest, the best, the center of the world. A thousand attractions call to you, a million lights turn the night into magic, and everywhere you look the city is alive with its own throbbing beat. Don't miss this great opportunity to enjoy New York on your own at the beginning of your cruise to Canada and the thrilling northeast.

The Great Lady Reborn
Standing straight and tall off Battery Park, Miss Liberty at 100 is as much a marvel of engineering as she is a model of inspiration. Her famous copper form, sculpted by Auguste Bartholdi, hides an intricate armature designed by Gustave Eiffel, more famous for his Paris tower.

Despite her beauty, she was not an easy sell. It took the media muscle of Joseph Pulitzer to turn the tide of American opinion and get the project underway. But once her strong, serene figure was in place, she won the hearts of the world. A century later, the public responded once again – this time with voluntary funds to repair and restore her in time for her centenary celebration.

Oh, Montreal
Founded in the 16th Century as a French fur station, Montreal boasts a wealth of historical interest, as well as the striking modern complexes built for Expo 67 and the 1976 Olympics. Shopping attractions range from antiques to the latest fashions, particularly in furs and fine woolens.

The French love of fine cuisine survives in Montreal, as does an active cultural life in theater, film and music. And the city is surrounded by the abundance of Canada's beautiful lakes, rivers and mountains.

Don't miss exploring the heart of French-speaking Canada. Plan to stay in Montreal after your cruise!

A lively street in Old Quebec ... Just like a visit to France!

PORTS OF CALL

NEW YORK Truly America's world-class city, block-for-block no other town on earth offers more sheer excitement than does Manhattan. The glitter and glamour of Broadway, the bustle of Wall Street, the elegance of Park Avenue, the style and verve of SoHo, the hush of Central Park, the thrill of the great museums and the Bohemian air of Greenwich Village – all packed in amongst the gleaming towers of glass and steel that set the world standard for elan.

Where else but in New York? See it all on your own at the beginning of your cruise – we'll help you make special air arrangements to accommodate whatever length of stay you wish.

CAPE COD CANAL A canal across the narrow neck of Cape Cod was first considered in 1623, but nearly three centuries were to pass before it finally opened in 1918. Today, merchant and pleasure boats negotiate the beautiful seventeen-mile waterway night and day, between Buzzards Bay and Cape Cod Bay, past lovely tree-lined banks and tranquil green parkland.

BAR HARBOR, Maine Sun, sea and glistening granite shores have long been an attraction along Maine's Atlantic coast, and nowhere are these more delightfully blended than on Mt. Desert Island. Small wonder that the great tycoons chose Bar Harbor as the site for their palatial "Summer Cottages."

Artists and yachtsmen, too, flock here in summer, and the rockbound harbor is alive with graceful racing craft, lying alongside the sturdy boats of local lobstermen.

At this season, the town is quieter, and perhaps a bit more friendly. Stroll down to the quay and visit with an old salt mending his traps, or make a short excursion to the pine forests of Cadillac Mountain, the highest peak on the Atlantic coast.

HALIFAX, Nova Scotia As Scottish as a tartan kilt and salty as a cod, Halifax is a city firmly rooted in two traditions. Britain and the sea.

Long a bastion of England's imperial presence in the Americas, the city is filled with historic monuments and graceful Georgian facades such as Province House, the oldest government building in Canada.

Reared on fishing and the sea, the hardy Nova Scotians steadfastly preserve this maritime heritage. Even in an age of satellite navigation, picturesque lighthouses mark the sea routes along Nova Scotia's rocky shores.

SAGUENAY FJORD Flowing from Lake Saint Jean down to the St. Lawrence River, the Saguenay boasts steep granite cliffs soaring up to 1500 feet, as breathtaking as the fjords of Norway. Famed for its frequent sightings of feeding whales, this unforgettable natural wonder can only be fully appreciated by ship.

QUEBEC
Dominated by the castle spires of Chateau Frontenac, Quebec viewed from the broad St. Lawrence might as easily be an ancient walled town on the Loire or the Seine.

And this gem of French Canada will do nothing to spoil the illusion once you step ashore, for the language, the traditions and even the cuisine of the exuberant Quebecois remain frankly Gallic despite political history.

Wander through the charming outdoor cafes along the Grand Allee, or browse the market stalls in Place Royale, and let Quebec cast her seductive spell on you – transporting you from the New World into the Old.

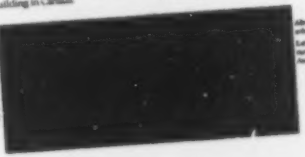
MONTREAL On your own at the end of your cruise, explore Canada's largest city. Montreal also proudly claims to be the largest French-speaking city outside Paris, and like Paris, it is a vital, modern place, a center for finance, fashion and the arts. Yet here, too, the glories of the past are honored and preserved.

A ride on the famous ultra-modern Metro subway system may lead you to glittering arcades of fashionable shops tucked under busy streets above, or to a treasured historic manor house like Chateau de Ramezay, now artfully restored to its former grandeur.

Don't neglect a visit to Mont Royal, the summit of the town, where a panoramic view reveals the blend of old and new that makes Montreal unique.

The futuristic pavilions of the World Expo and the Olympic facilities draw thousands of admirers, while for nature lovers, the scenic splendor of the Laurentian Mountains waits not far away.

Above left: A town crier evokes the spirit of the 18th century.
Right: Peggy's Cove, Nova Scotia – an enchanting fishing village.



Above right: Montreal where old meets new.
Left: Leaves begin to turn to their marvelous Autumn colors.

YOUR ITINERARY DEPARTING SEPTEMBER 6, 1988			
NEW YORK to MONTREAL			
Date	Port	Arrive	Depart
Air Flight			
6 Sep.	U.S. City Departure		Morning
6	New York	Afternoon (Board Ship)	
Ship Schedule			
6	New York		Evening
9	*Cruise the Atlantic Ocean/Transit the Cape Cod Canal (Tides Permitting)*		
10	Bar Harbor, Maine	Early Morning	Afternoon
11	Halifax, Nova Scotia	Morning	Late Afternoon
12	*Cruise the Atlantic Ocean & St. Lawrence River*		
13	Saguenay Fjord—Cruise Through (Weather Permitting)	Morning /	Evening
14	Quebec, Canada	Early Morning	Evening
15	Montreal, Canada	Morning (Disembark Ship)	
Air Flight			
15	Montreal		Morning
15	U.S. City Return	Afternoon/Evening	

OPTIONAL EXTENSION

Begin your cruise with a very special inaugural Transatlantic Crossing in the Grand Tradition. You'll board the *Royal Odyssey* in London and enjoy eight days and nights of nonstop excitement, fun and entertainment reminiscent of the great crossings of the 20's and 30's. For a small additional cost, you can also enjoy a 2- or 4-night pre-cruise London Theatre Break, including deluxe hotel accommodations, tickets to a popular London play, and a special Art Deco Gala Ball.

YOUR ITINERARY DEPARTING AUGUST 30, 1988 (Optional)			
LONDON TO NEW YORK			
Date	Port	Arrive	Depart
Air Flight			
30 Aug.	U.S. City Departure		Evening
31	London	Afternoon (Board Ship)	
Ship Schedule			
31	London/Tilbury		Late Afternoon
1 Sep.	*Cruise the English Channel*		
2	*Cruise the North Atlantic Ocean*		
3	*Cruise the North Atlantic Ocean*		
4	*Cruise the North Atlantic Ocean*		
5	*Cruise the North Atlantic Ocean*		
6	*Cruise the North Atlantic Ocean*		
7	*Cruise the North Atlantic Ocean*		
8	New York	Morning (Disembark)	
Air Flight			
8	New York		Morning/Afternoon
8	U.S. City Return		Afternoon

Pre-cruise London Theatre Break will add extra days to this itinerary.

THE INDIANA UNIVERSITY ALUMNI ASSOCIATION

Special Bonus Amenities:

- ★ $50 per person shipboard credit
- ★ A special hosted Bloody Mary party on board
- ★ A "Get Acquainted" Alumni cocktail reception
- ★ One group photograph per couple
- ★ Souvenir Name Badges

COMPLETE AIR•SEA CRUISE PACKAGE FROM INDIANAPOLIS

STATEROOM CATEGORY	TYPE OF ACCOMMODATIONS	PER PERSON	
		8-Day Cruise Fares	17-Day Cruise Fares*
A	Superior Deluxe Suite/Promenade Deck/bedroom-sitting area/window(s)/tub/shower	$3138	$4577
B	Superior Deluxe Suite/Promenade & Marina Decks/bedroom-sitting area/windows/tub/shower	2958	4397
C	Deluxe Jr. Suite/Promenade, Odyssey & Marina Decks/bedroom-sitting area/window/shower	2778	4217
D	Superior Deluxe Outside Stateroom/Riviera & Promenade Decks/window/tub/shower	2598	3937
E	Superior Deluxe Outside Stateroom/Odyssey Deck/window/tub/shower	2463	3902
F	Superior Deluxe Outside Stateroom/Marina Deck/window/tub/shower	2418	3757
G	Deluxe Outside Stateroom/Marina Deck/window/shower	2373	3712
H	Deluxe Outside Stateroom/Marina Deck/window/shower	2283	3622
I	Deluxe Outside Stateroom/Laguna Deck/porthole/shower	2238	3577
J	Deluxe Outside Stateroom/Laguna Deck/porthole/shower	2193	3532
K	Deluxe Outside Stateroom/Laguna & Coral Decks/porthole/shower	2148	3487
L	Deluxe Outside Stateroom/Coral Deck/porthole/shower	2103	3442
M	Deluxe Outside Stateroom/Coral & Playa Decks/porthole/shower	2058	3397
N	Deluxe Inside Stateroom/Riviera, Promenade & Marina Decks/shower	1923	3262
O	Deluxe Inside Stateroom/Laguna Deck/shower	1878	3117
P	Deluxe Inside Stateroom/Laguna & Coral Decks/shower	1833	3072
Q	Deluxe Inside Stateroom/Playa Deck/shower	1788	3027

All fares are per person, double occupancy. Additional rates for single supplement and 3rd or 4th person will apply (ask your Travel Consultant for details). Deposit: $400 per person. Port charges: $49, $98*

Airfare add-on fare from Chicago: $100 (both sailings)

A B
C
D/E F
G H
I/J K/L/M
O/P Q

USACANP088 LITHO IN U.S.A.

ROYAL CRUISE LINE • AIR/SEA FEATURES

YOUR FLIGHTS

You'll board your regularly scheduled airline flight and fly directly to your destination. During your flights, you'll enjoy complete meal and cocktail service. Your return flight is equally as pleasant and comfortable.

YOUR LUGGAGE

Two pieces of check in luggage per person, plus carry on bags! More than ample allowance for your cruise clothes and those special shopping treasures.

TRANSFERS, TAXES AND TIPS

You will be met at the airport and transferred to and from your *Odyssey*. Your luggage will be delivered directly to your stateroom. U.S. and foreign airport taxes are included, as well as tips for luggage handling once you've checked in for your final flight.

SHORE EXCURSIONS

Shore excursions at all appropriate ports-of-call will be available at an additional cost aboard ship or in an advance purchase package.

CONDITIONS: Royal Cruise Line (U.S.A.), Inc. [RCL USA] acts as suppliers' agent for tours, and is not liable for damages, losses, injury or death resulting from acts, omissions, or negligence of any provider of services or accommodations; or due to other causes beyond the control of RCL USA, and passengers waive claims against RCL USA arising therefrom. RCL USA may refuse passage to anyone at any time, with proportionate refund for unused services or accommodations, and may substitute itineraries, comparable services or accommodations for causes that RCL USA can't control, or for passenger well being; this may be done without refund. RCL USA may increase prices prior to departure due to increases in suppliers' prices, or currency exchange rate changes.

CANCELLATIONS received in writing 60 or more days before departure will result in full refund; otherwise the cancellation charge per passenger will be $200 for cancellations 30 to 60 days prior, and 50% of tour price for cancellations 0 to 30 days prior. Resale of cancelled space in the same category will reduce such charges to $100 per person plus any airline penalty. No refunds will be made for passenger's nonuse of services or accommodations.

AIR TRANSPORTATION on charters may be substituted for scheduled flights or vice versa, and routings may be changed by RCL USA. Transportation to and from departure cities, and schedulings or routings made by passengers, travel agents or airlines are not the responsibility of RCL USA.

BAGGAGE check-in allowance per passenger is two pieces each with no weight restriction, but with maximum aggregate length, width and height dimensions of 62", and 107" for both pieces combined. Carry-on bag(s) must fit beneath one aircraft seat, and be a maximum length, width and height of 45". RCL USA is not responsible for baggage loss, theft or damage.

DOCUMENTS: U.S. Citizens must have a valid U.S. Passport. For cruises calling at the ports of Yalta, Odessa and Leningrad, passengers taking the Royal Cruise Line excursions will not need to obtain Soviet Visas. Passengers wishing to go ashore independently must obtain individual Soviet Visas prior to departure. Other nationalities contact Royal Cruise Line.

REGISTRY of the *Royal Odyssey* is Greece.

CRUISE PORTIONS OF FARES are guaranteed at the published rates in effect at the time of receipt of deposits.

DEPOSIT & FINAL PAYMENT: A $400 per person deposit confirms reservations and indicates the passenger's acceptance of the Conditions and Terms of this brochure. Final payment is due 60 days prior to departure. The Crown Card, Master and Visa Cards are accepted. RCL USA is responsible for passenger's funds only if payment is by check payable to RCL USA.

TRAVEL AGENTS WHO ARE CLIA BONDED will be deemed agents of RCL USA with respect to passage fares remitted to them and all other travel agents will be deemed agents of the passengers with respect to passage fares remitted to them. RCL USA will be pleased to advise potential passengers as to which travel agents are CLIA bonded.

Indiana University Alumni Association
AREA CODE 812/335-1711

INDIANA MEMORIAL UNION/M-17/BLOOMINGTON, INDIANA 47405

Dear Alumni:

We are pleased to invite you to join our special September 11 cruise of The Best of China, Japan, and the Orient.

Imagine seeing the splendor of the Orient on this fabulous itinerary while enjoying Royal Cruise Lines' Golden Odyssey. This ship is universally acclaimed as one of the most elegant of cruise liners. Her dining service and the intimate warmth of the all Greek crew, have made her the favorite of Americans-- She caters exclusively to an American clientele.

This luxurious air/sea cruise is priced from only $3763.00 per person. The availability of staterooms is limited, so we urge you to respond as soon as possible to reserve the accommodations of your choice.

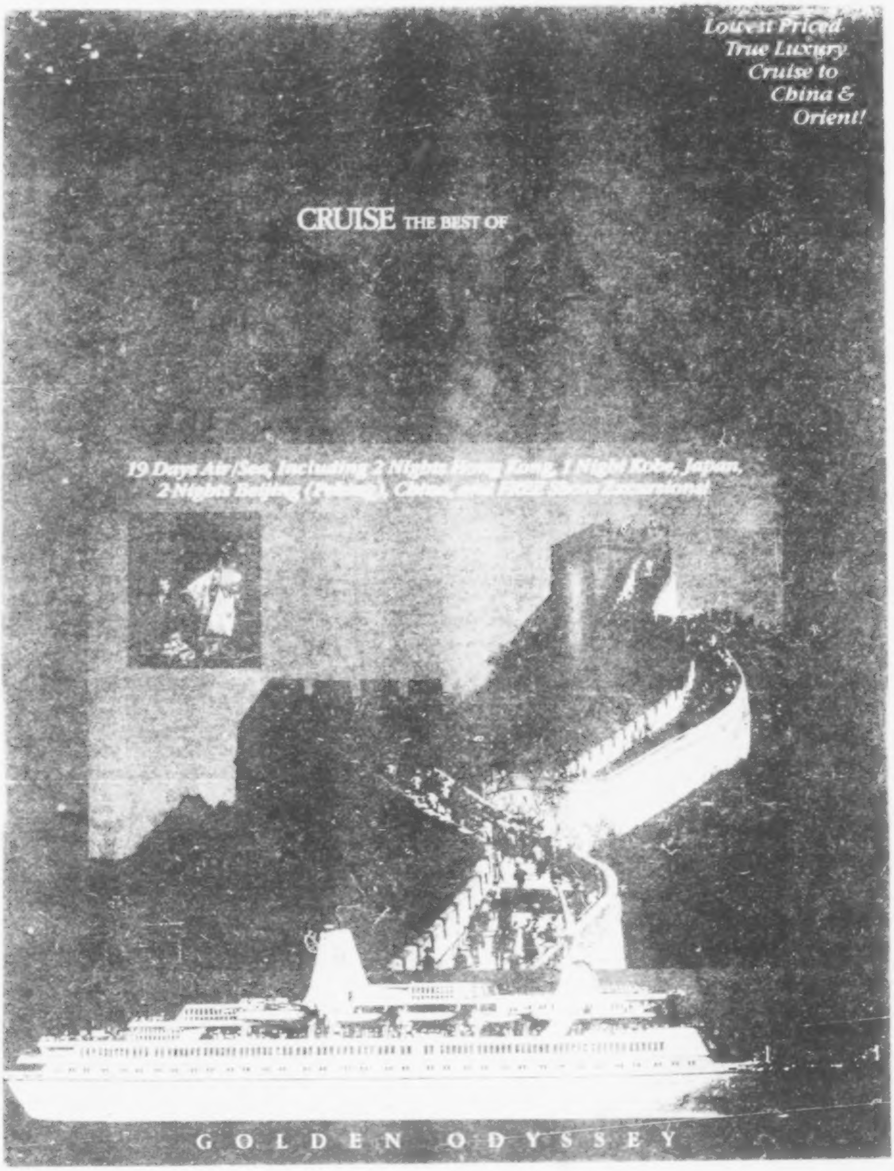
Sincerely,

Frank B. Jones

Frank B. Jones
Executive Director
Indiana University
Alumni Association

P.S. Please note that all shore excursions are included as well as land programs in Hong Kong, Beijing (Peking), and Kobe, Japan!

Winner of fourteen national Alumni Administration awards for comprehensive excellence in alumni programming


Lowest Priced
True Luxury
Cruise to
China &
Orient!
CRUISE THE BEST OF
19 Days Air/Sea, Including 2 Nights Hong Kong, 1 Night Kobe, Japan,
2 Nights Beijing (Peking), China, and FREE Shore Excursions!
GOLDEN ODYSSEY

China. The world's oldest, most fascinating civilization, a treasure trove of magic and mystery, a magnificent travel experience that you will savor all your lifetime.

[illegible]

Your elegant Golden Odyssey. [illegible]

Dazzling days and nights. [illegible]

Dining out every day. [illegible]

FREE ORIENT LAND PACKAGES

[illegible]

FREE 2-NIGHT "HONG KONG MAGIC" PACKAGE INCLUDES

[illegible]

HONG KONG MAGIC 3-NIGHT [illegible]

FREE OVERNIGHT KOBE PACKAGE INCLUDES

[illegible]

Kyoto Option. [illegible]

Free Shore Excursions in these Fabulous Ports!

All shore excursions in China are included in the price of your cruise... including hotels and meals in Beijing. Also included are ½ day tours in Hong Kong, Nagasaki, Pusan and Kobe.

HONG KONG. [illegible]

SHANGHAI, China. [illegible]

YANTAI, China. [illegible]

BEIJING, China. [illegible]

PUSAN, Korea. [illegible]

NAGASAKI, Japan. [illegible]

INLAND SEA. [illegible]

KOBE, Japan. [illegible]

YOKOHAMA, Japan. [illegible]

YOUR ITINERARY DEPARTING SEPTEMBER 11, 1986 HONG KONG TO KOBE			
Date	**Port**	**Arrive**	**Depart**
Air Flight			
11 Sept.	U.S. Departure		Late Afternoon
	Cross International Date Line		
Pre-Cruise "Hong Kong Magic"			
12	Hong Kong (Hotel)	Evening	
13	Hong Kong (Hotel)		
Ship Schedule			
14	Hong Kong	Afternoon (Board Ship)	Evening
15	*Cruise the South China Sea*		
16	*Cruise the East China Sea*		
17	Shanghai	Early Morning	
18	Shanghai		Evening
19	*Cruise the Yellow Sea*		
20	Yantai, China	Mid-day	Evening
21	Beijing	Early Morning (Transfer to Hotel)	
22	Beijing (Hotel)		
23	Beijing (Reboard Ship)		Evening
24	*Cruise the Yellow Sea*		
25	Pusan, Korea	Mid-Day	Evening
26	Nagasaki, Japan	Early Morning	Afternoon
27	Kobe, Japan	Evening	
28	Kobe		Morning (Disembark)
Post-Cruise Stopover			
28	Kobe (Hotel)		
Air Flight			
29	Kobe		Afternoon
29	U.S. Return	Evening	

There Is No Vacation Value Like a Royal Cruise Line Air/Sea Cruise.

Here's what is included:

AIR TRANSPORTATION: Air/Sea passengers are provided roundtrip flights via scheduled airlines on Apex and other reduced fares.

CHECK-IN ASSISTANCE: RCL staff will assist air/sea passengers with check-in at most major gateways for transpacific and transatlantic flights.

ESCORTED FLIGHTS: RCL Escorts accompany air/sea passengers on most transpacific and transatlantic flights.

FREE BAGGAGE ALLOWANCE: Air/Sea passengers are not restricted by weight. Passengers may bring two large suitcases plus hand luggage that will fit under an aircraft seat.

SERVICE & TRANSFERS: All air/sea passengers (and independent passengers arriving on the same flight) are met by RCL staff and TAKEN DIRECTLY TO SHIP OR HOTEL. Luggage, gratuities, and airport taxes are included in trans-oceanic flights.

DINING: Three delicious meals daily featuring Continental and American specialties are included aboard ship. In addition, you'll enjoy special buffets, midnight snacks and free 24-hour room service.

CREW: Our warm, caring and efficient Greek Stewards will cater to your every need in your stateroom, the dining room, bars and on deck.

CRUISE STAFF: Our cruise director and his staff are ready to assist you with all your special needs, sightseeing and shore excursions.

LECTURES: On all cruises, you will be invited to interesting and informative lectures on the culture, history, sightseeing and shopping of each port visited.

SPECIAL EVENTS: You will be invited guests of RCL at the Captain's Cocktail party and Gala Farewell Dinner in addition to many other special events and festivities.

SHORE EXCURSIONS: Royal Cruise Line offers a variety of optional shore excursions which may be purchased in advance or on board. Passengers wishing to sightsee on their own also will be assisted in every way.

ON-BOARD ENTERTAINMENT: Every night aboard ship a special show will be presented including passenger participation nights and Greek night.

SPECIAL ACTIVITIES: Exercise classes, dance classes, Greek dancing, fitness center, sauna, walkathon, bridge tournaments, deck tennis, ping pong and other activities are all FREE.

NO REGIMENTATION: You may participate in as many activities as you wish, or none. It is up to you.

The Indiana University Alumni Association

Special Bonus Amenities:

★ $150 per person Shipboard Credit on board
★ A Special Group Photograph
★ A Bloody Mary Cocktail Party
★ A "Get Acquainted" Cocktail Party on board
★ Special Souvenir Name Badges

1

6/8/9

CONDITIONS: Royal Cruise Line Limited (RCL Ltd.) acts as supplying agent for tours, and is not liable for damages, losses, injury or death resulting from acts, omissions, or negligence of any provider of services or accommodations, or due to other causes beyond the control of RCL Ltd., and passengers waive claims against RCL Ltd. arising therefrom. RCL Ltd. may refuse passage to anyone at any time, with proportionate refund for unused services or accommodations, and may substitute itineraries, comparable services or accommodations for causes that RCL Ltd. can't control or for passenger well being; this may be done without refund. RCL Ltd. may increase prices prior to departure due to increases in suppliers' prices, or currency exchange rate changes.

RESPONSIBILITY: All arrangements for the itinerary within China are solely at the discretion of the China International Travel Service (CITS) and their branches who control the final scheduling of destinations, cities and sightseeing programs. RCL Ltd. and/or its agent Blue Sea, have no control over this portion and cannot be held responsible for changes. Cities cited in the itineraries are those supplied by the Chinese tourist authorities and may be changed by them. The final itinerary for the tour is detailed for participants on arrival in China.

Acceptance by RCL of any passenger's reservation is not a guarantee of approval and issuance of a visa of entry into the People's Republic of China. In the event that any visa application is rejected, RCL Ltd. will refund in full any payments made for the tour and such refund will absolve RCL Ltd. of any claims.

If a tour is cancelled by CITS or any other department in China, full refund will be made for the tour and such refund will absolve RCL Ltd. and its agents of any further responsibility.

CANCELLATIONS received in writing 60 or more days before departure will result in full refund, otherwise the cancellation charge per passenger will be $200 for cancellations 30 to 60 days prior, and 50% of tour price for cancellations 0 to 30 days prior. Resale of cancelled space in the same category will reduce such charges to $100 per person plus any airline penalty. No refunds will be made for passenger's nonuse of services or accommodations.

AIR TRANSPORTATION on charters may be substituted for scheduled flights or vice versa, and routings may be changed by RCL Ltd. Transportation to and from departure cities, and schedulings of routings made by passengers, travel agents or airlines are not the responsibility of RCL Ltd.

BAGGAGE: Check-in allowance per passenger is two pieces, each with no weight restriction, but with maximum aggregate length, width and height dimensions of 62" and 107" for both pieces combined. Carry-on bags must fit beneath the aircraft seat, and be a maximum length, width and height of 45". RCL Ltd. is not responsible for baggage loss, theft or damage.

DOCUMENTS: U.S. Passport is required. Passengers participating in shore excursion programs offered at Chinese ports will be covered by a group visa obtained by RCL Ltd.

Those passengers wishing to travel "on their own" will need to obtain—prior to departure from the United States—Chinese Tourist Visas for each Chinese port, specifying the cities they will sightsee on their own.

All passengers will need to obtain, IN ADVANCE OF DEPARTURE, a Japanese Tourist Visa.

REGISTRY of the Golden Odyssey is Greece.

CRUISE PORTIONS OF FARES are guaranteed at the published rates in effect at the time of receipt of deposits.

DEPOSIT & FINAL PAYMENT: A $400 per person deposit confirms reservations and indicates the passenger's acceptance of the Conditions and Terms of this brochure. Final payment is due 60 days prior to departure. The Diners Club, MasterCard and Visa cards are accepted. RCL Ltd. is responsible for passenger's funds only if payment is by check payable to RCL Ltd.

INSURANCE: We strongly recommend that you purchase comprehensive travel insurance. Ideally, this insurance should cover medical expenses including hospitalization, personal accident, baggage cover (including lost and/or delayed luggage), travel delay, tour cancellation and/or curtailment and loss of money and/or travel documents/tickets. Your travel agent can arrange this for you.

MEDICAL RESTRICTIONS: Persons who are not medically fit should not participate in these tours. This includes, but is not necessarily limited to, persons with mental illness, heart disease, a serious chronic or contagious disease, or a physical handicap or infirmity. Also, pregnant women should not participate.

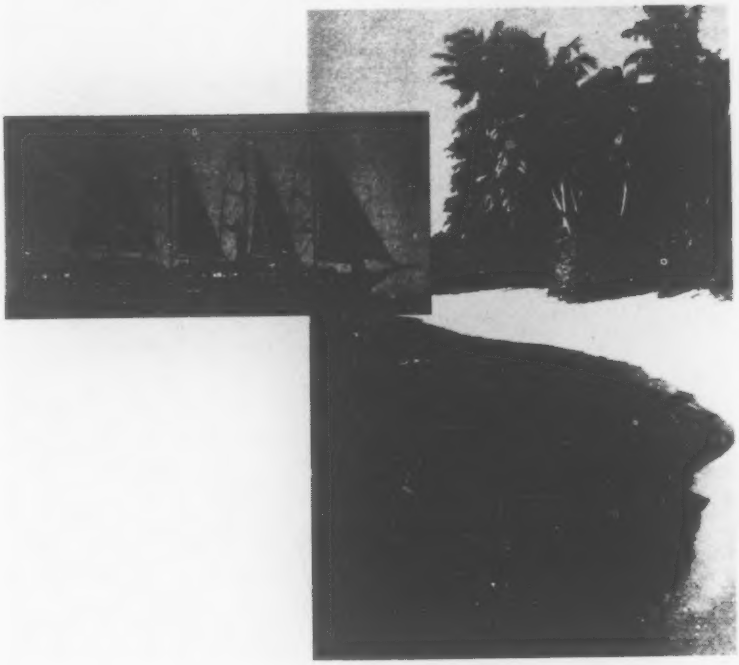
Inoculations or vaccinations are not required except for passengers traveling from an infected area.

C-RTG0861 LITHO IN U.S.A.

Sponsored by
The Indiana University Alumni Association

Sail The Lesser Antilles

Aboard Wind Star
February 21 to February 28, 1987



WINDSTAR

The 440-foot, 150-passenger, four-masted Wind Star represents a revolutionary concept in cruising that combines for the first time, modern computer technology with the romance of sailing. Wind Star is the first of a fleet of ships.

As the ship weighs anchor and heads out to sea, her sails, on 204-foot high masts, snap in the wind, and Wind Star glides across the surface of crystalline waters. You feel a previously unknown closeness to the sea as the sun warms your skin in this tropical climate.

Excitement is in the cooling breeze as the ship's state-of-the-art computer system, operated by experienced Norwegian officers, responds to the constantly changing action of the sea, and leads you to inviting, secluded ports not accessible to traditional cruise ships.

Each of the 75 identical, 185-square-foot cabins has a view of the sea and includes twin beds which convert to a queen-size bed if preferred.

Amenities include private bath with shower; an entertainment center featuring videocassette player, color television, and stereo; a mini-bar and direct-dial ship-to-shore telephone.

Interiors of traditional nautical design offer uncluttered spaciousness, warmed by natural materials — muted leathers and mixed woods.

Dining is another pleasure aboard the Wind Star. Sample French, European and New American recipes as well as specialties prepared from fresh vegetables, fruits and seafoods purchased at markets in ports of call. And if your day of angling is successful, the chef will happily prepare your catch for dinner.

Breakfast and a luncheon buffet will be served by an Italian dining staff in the open-air Veranda. You can dine inside or outdoors. In the evening, dinner is at the time of your choice during a single leisurely open sitting in the main dining room. Then finish your night aboard ship by enjoying live music, casino gambling or dancing.

A cruise on Wind Star will, for the first time, combine modern amenities with a sailing vessel specifically designed so that passengers can truly enjoy the beauty of the sea.

Experience the joy of sailing when the Wind Star's sails unfurl, catch the wind and ease the ship from its berth in Fort de France, Martinique. Glide past the lush green banana plantations of St. Lucia's western shores to reach Marigot Bay, and discover the pleasures of this naturally protected lagoon that yachtsmen regard as one of the world's most beautiful. As the Wind Star remains anchored for an entire day, there is plenty of time to explore the mountainous interior of this verdant, volcanic island.

Pristine islands and cays of the leeward chain of the Grenadines offer extraordinary beauty as the Wind Star charts her path to the next ports. First, sample the Creole cooking and charismatic native nightlife of Bequia.

Then, sail to Tobago Cays the following day and swim or snorkel past the colorful underwater coral and sealife. When evening comes, head towards the nearby privately-owned islet of Mayreau for a romantic sunset sail.

Courtesy of French W. Indies Tourism

Fort-de-France Harbor, Martinique

Wind Star Schedule of Navigation

Day	Port of Call	Arrival	Departure
Saturday	Martinique	◆	12:00 Midnight
Sunday	St. Lucia (Marigot Harbor)	12:00 Noon	◆
Monday	St. Lucia	◆	[illegible] AM
	Bequia	2:00 PM	◆
Tuesday	Bequia	◆	[illegible] AM
	Tobago Cays	12:00 Noon	[illegible] PM
	Mayreau	11:00 PM	◆
Wednesday	Mayreau	◆	[illegible] AM
	Grenada	12:00 Noon	◆
Thursday	Grenada	◆	[illegible] AM
	Palm Island	[illegible] AM	[illegible] PM
	Mustique	[illegible] PM	◆
Friday	Mustique	◆	[illegible] AM
	St. Lucia (Pigeon Point)	2:00 PM	◆
Saturday	St. Lucia	◆	[illegible] AM
	Martinique	[illegible] AM	◆

Please note that navigation under sail is subject to weather and wind conditions.

Reach historic Grenada, known for its white-sand beaches and old spice trade. Explore the winding streets of hilly St. George and admire the serene surrounding countryside where nutmeg, cloves and cinnamon scent the air. During the afternoon, enjoy golf, tennis, hiking and high tea at local clubs; or participate in the many Wind Star watersports that are always available.

Next, spend a morning at Palm Island where passengers can deep-sea fish off nearby Union Island before enjoying an enchanting evening at Mustique, the celebrated island retreat of Princess Margaret and many celebrities.

On the last day at sea, explore Pigeon Point, a verdant island parkland which boasts Arawak Indian remnants. Sunbathe, stroll the beaches and paths, or horseback ride during the visit to St. Lucia.

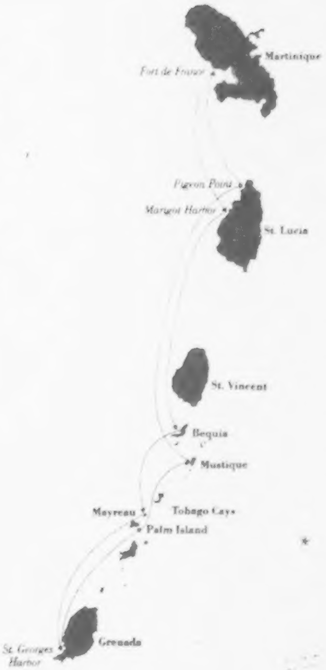
Enjoy once more the freedom of the sea as the ship sails the final leg of the journey and returns to Fort de France, Martinique.

State-of-the-art computer technology has gone to sea aboard Wind Star. On-board computers constantly monitor sailing conditions, adjusting the stand of the booms and the furl of 21,500 square-feet of sail.

The system also controls the anti-heeling tanks to limit the deck angle to six degrees. The result: optimum navigation and passenger comfort. An override mechanism lets the captain sail by his own judgment. There are three diesel-electric engines producing electricity for propulsion and ship support systems. The ship has retractable fin stabilizers to ensure passenger comfort.

Courtesy of French W. Indies Tourism

Grand Ballet de la Martinique



On Board Wind Star

Officers and Crew
Norwegian officers. European hotel staff. Total officer and crew complement: 80.

Dining
Breakfast and lunch are served in the Veranda. Continental breakfast is available in the passengers' cabins. The Restaurant is open for dinner from 7 p.m. to 10 p.m. Open sitting. 24-hour cabin sandwich service is available.

Shipboard Facilities
The following facilities are offered on board Wind Star: Hairdresser and beauty salon, sundry and boutique, discotheque, casino with blackjack tables and slot machines, video cassette and book library, gymnasium, sauna, outdoor swimming pool. There are no elevators on board.

Sports Equipment
In keeping with The Wind Star Concept, the Wind Star is equipped with the following: Sailboats, windsurfer boards, 8 Sillinger boats, scuba and snorkeling gear, deep-sea fishing equipment, waterskis, volleyball, underwater cameras.

Payments on Board
All purchases made on board are charged to your cabin account and settled at the end of the cruise. The currency on board is U.S. dollars. For convenience and safety, major credit cards and travelers' cheques are accepted.

Laundry
Laundry service is provided at a charge. Dry cleaning facilities are not available.

Medical Services
A doctor and hospital facilities are on board.

Indiana University

Dear Alumni:

Many of you have traveled with us in the past to the *Caribbean* on traditional cruise ships. Here is a unique opportunity to explore the *Lesser Antilles* on the magnificent *Wind Star*. This sailing vessel is designed to be under sail every day through the use of computer operated sails. Imagine trimming 21,500 square feet of sail with the push of a button.

Embark the Wind Star in *Martinique* and begin a seven-night cruise as the ship's computer sets and adjusts the sails, heading south to *St. Lucia*, a picture-postcard island paradise. Next, discover some of the more remote islands of the *Grenadines* en route to *Grenada*. Finally, return to Martinique by a different route, seeing other links of the Eastern Caribbean Windward chain along the way.

Long and sleek, the recently-christened Wind Star features lavishly furnished interiors integrated with functional nautical design and contemporary comfort. Each of the all-outside cabins has the amenities of a fine international hotel plus ever-changing ocean panoramas. The dining room of the Wind Star serves savory foods inspired by New American cuisine, and the ship provides personalized services not possible on larger vessels.

Experience the intimacy of this elegant sailing ship while enjoying the camaraderie of fellow alumni on this very special, first-ever offering. Enjoy the watersports of your choice, bask on sun-drenched beaches, shop for quality European imports and lovely native handcrafts, or just simply enjoy the open sea under full sail.

Capacity on this marvelous sailing ship is limited so sign up without delay!

Sincerely,

Frank B. Jones

Frank B. Jones
Executive Secretary
University Director of Alumni Affairs

Sail The Lesser Antilles Included Features

- Seven days/seven nights round-trip cruise from Martinique aboard the deluxe sailing ship, Wind Star.
- Alumni welcome cocktail party aboard ship.
- All meals aboard the Wind Star.
- Shipboard gratuities for dining room staff and cabin steward.
- Port taxes during the cruise.
- All transfers and luggage handling between airport and the ship.
- Services of a Gohagan & Company travel director throughout the trip.
- Alumni flight bag, name badge, and passport wallet containing trip information sent to each participant's home in advance of departure.

Optional Pre-Cruise Program

Why not come down early? Before you join the cruise spend three days relaxing in the sun at a deluxe hotel on the lovely island of Martinique. Considered by many to be the most exotic of the West Indian Islands, Martinique features excellent cuisine, marvelous beaches and perhaps the best shopping in the Caribbean.

Optional Pre-Cruise Features:

- Three nights' accommodations at a deluxe hotel in Martinique.
- Transfers and luggage handling between the Martinique airport, hotel and ship.
- Welcome cocktail party.
- Gohagan & Company travel director to assist you throughout the pre-cruise program.

Full details available on request.

Tariff	**Cruise Rates** (Per person based on double occupancy)
All cabins are outside on either Deck 1 or Deck 2.	**$2250**
Single occupancy of cabin: 150% of double occupancy cruise fare. Singles on the ship are limited.	
Third Berth Persons – Sharing with two full-fare adults; available in selected rooms: 25% of the applicable double occupancy cruise fare.	
Special low air add-on to Martinique from Indianapolis or Chicago round trip at $305 additional per person. *This attractive low air add-on is the result of negotiations between Windstar Sail Cruises and the respective air carriers utilized. Neither Gohagan & Company nor the sponsoring organization has control over the air carriers selected, the routes flown nor the flight schedules utilized. Some restrictions do apply.*	

Travel arrangements by
Thomas P. Gohagan & Company
A service of Alumni Travel
and Alumni Colleges Abroad
224 South Michigan Avenue
Chicago, Illinois 60604
(312) 922-3882

General Information

Not included. Personal expenses such as laundry, telephone calls, alcoholic beverages, meals and gratuities not listed in the "Included Features," passport fees, optional sightseeing and shore excursions, and accident and baggage insurance.

Health: Any physical or mental condition which may require special medical attention, for example the need for a wheelchair, must be reported in writing when your reservation is made. There are no elevators aboard ship.

Cancellations and Refunds: Should you have to cancel your trip, the following terms will apply. Cancellations for the pre-cruise land program, cruise and/or air will not be effective until they are received in writing in the offices of Gohagan & Company. All cancellations are subject to a non-refundable $50 per person administrative charge.

Pre-Cruise Land Program: These fees for the pre-cruise land program are in addition to any applicable cancellation fees for the cruise and airfares. Pre-Cruise land program reservations are subject to a $50-per-person fee for any changes or cancellations made up to 61 days prior to departure. Cancellations from 1 to 60 days prior to departure will result in a cancellation fee of $150 per person. Cancellations within 24 hours of the pre-cruise departure or a no-show will result in a cancellation forfeiture of 100% of the pre-cruise land program.

Cruise: Full refund of all payments, less the $50, will be made for accommodations cancelled, up to and including 71 days before departure. Later cancellations will be subject to the following charges: 41 through 70 days prior to departure, $400 per person; 26–40 days prior to departure, 65% of trip price; 1–25 days prior to sailing, 90% of trip price. Cancellations within 24 hours of departure, or a no-show will result in forfeiture of 100% of the tour cost. An early return from the program will result in forfeiture of the entire tour cost. These cancellation fees are for the ship and are in addition to any applicable cancellation fees for the pre-cruise land package and airfares.

Air Transportation Conditions and Changes: Windstar Sail Cruises reserves the right to change the air carrier, routing and schedule from each city. Most airline tickets issued by Windstar Sail Cruises are restrictive due to the type of air fare used. Therefore, you may find that your ticket cannot be rerouted or exchanged for another air carrier or routing. Cancellations or rebooking charges may be assessed by the airlines for any changes made to the air ticket issued by Windstar Sail Cruises. These charges are the sole responsibility of the passenger.

Air add-ons are based on airfares in effect at time of printing and Windstar Sail Cruises reserves the right to increase prices. In addition to the above cancellation fees, airline policies may require a fee if your reservation is changed or cancelled within 30 days of departure. These fares will be based on a special economy class fare. Changes in airline reservations after departure will result in higher air fares. Participating airlines are all IATA and ARC member carriers.

We strongly recommend that you purchase trip cancellation insurance. We will send you an application after you reserve.

Responsibility: Thomas P. Gohagan & Company and the sponsoring association act only as agents for the passenger with respect to travel services. We can assume no responsibility nor liability in whole or in part for any delays, delayed departure or arrival, missed carrier connections, loss, damage or injury to person or property or mechanical defect, failure, or negligence of any nature howsoever caused in connection with any accommodations, restaurant, transportation or other services or for any substitution of hotels or of common carrier equipment beyond our control, with or without notice, or for any additional expenses occasioned thereby. Baggage is at the owner's risk throughout the tour, unless insured. The cruise passenger waives any such claim against Gohagan and Company and the sponsoring association for any such damage. The right is reserved to decline to accept or retain any person as a member of this tour at any time, in the sole judgment of Gohagan & Company, should they be of such physical or mental condition as to be unfit for travel, or who may require care and attention beyond what we can provide.

No revision of the printed itinerary or the "Included Features" is anticipated; however, the right is reserved to make any changes, with or without notice, that might become necessary, with the mutual understanding that any additional expenses will be paid by the individual passenger.

The cruise line, airlines and other transportation companies concerned are not to be held responsible for any act, omission, or event, during the time passengers are not on board their conveyances. The contract of passage and this "General Information" in use when issued, shall constitute the sole contract between the companies and the purchaser of these tours and/or passenger. The Contract of Passage will be sent to you with your final documents and you should review it before departure.

Rates: All prices quoted are based on June, 1986 tariffs, rates of exchange and fuel prices, and are subject to change [illegible] the time of tour departure.

Sail The Lesser Antilles *Reservation Form*

Send to: IUAA Educational Tours
Alumni Association
IMU/M-17
Bloomington, IN 47405

I am requesting ________ reservation(s), and have enclosed my check for $ ________ as deposit ($650 per person). **Make checks payable to 1987 Lesser Antilles.**

Name(s)

First ____ *Initial* ____ *Last* ____ *Class Year* ____

First ____ *Initial* ____ *Last* ____ *Class Year* ____

Address ________

City ____ *State* ____ *Zip Code* ____

Telephone: (Home) ____ *(Office)* ____

☐ I prefer single accommodations at a cost of 150% of the double occupancy cruise tariff. (Singles on the ship are limited.)
☐ I am reserving as a single but wish to share accommodations (shares cannot be guaranteed).
☐ I/we would like to participate in the 3-night pre-cruise land package at an additional cost to be advised.
☐ I/we do not want to participate in the optional pre-cruise land program.
☐ I/we prefer non-smoking section whenever possible.
☐ Smoking preferred.

I/we prefer to depart from:
☐ Indianapolis at $305 additional per person round trip.
☐ Chicago at $305 additional per person round trip.

☐ Other ________
(Major City)

Special low cost air fares and getaways available on request.

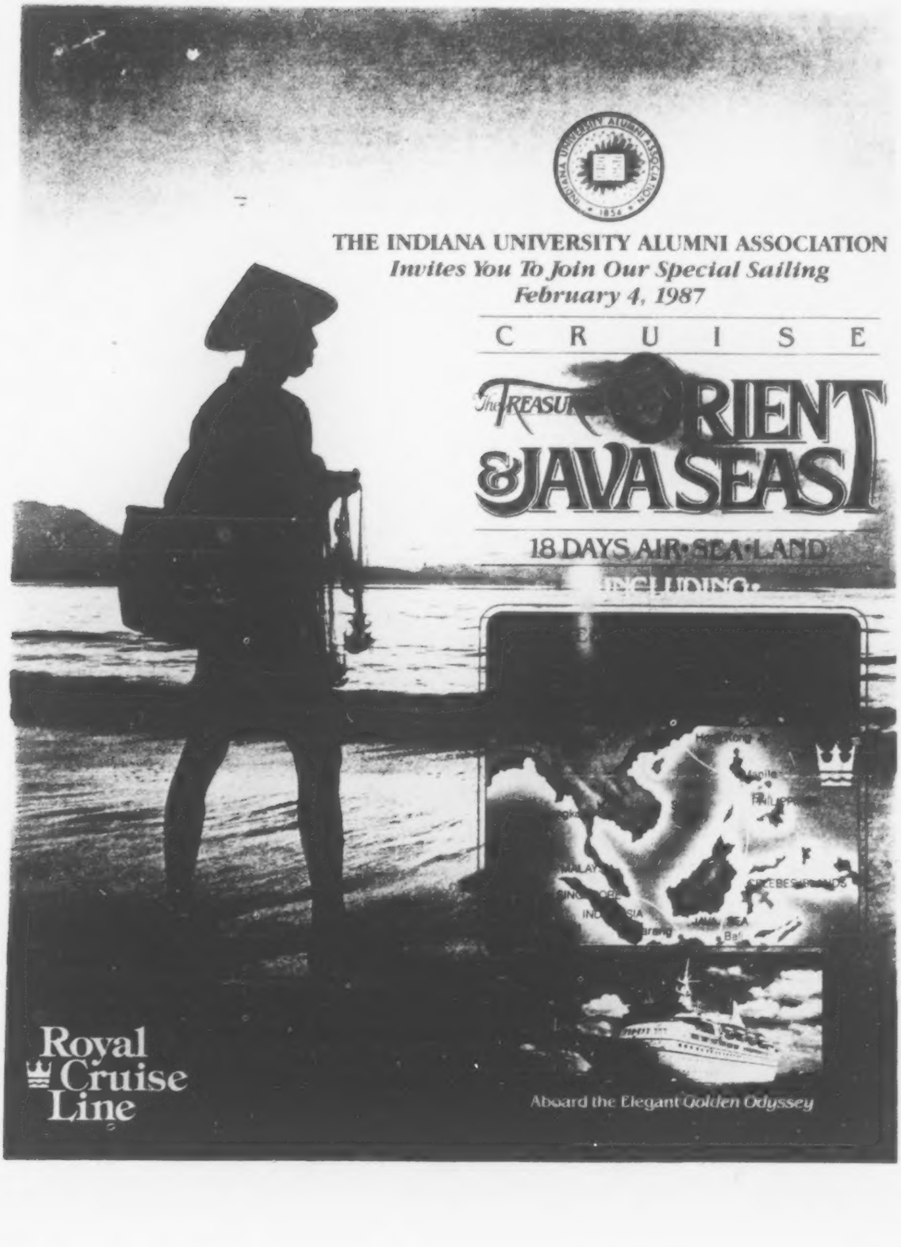
TRIP PRICE TO BE PAID IN FULL BY DECEMBER 13, 1986.

IUAA Educational Tours
Alumni Association
Indiana Memorial Union/M-17
Bloomington, IN 47405

Non-Profit Org.
U.S. Postage
PAID
Indiana University
Alumni Association

Ship's Registry: Bahamas © 1986 Windstar Sail Cruises Limited

Printed in U.S.A.



THE INDIANA UNIVERSITY ALUMNI ASSOCIATION
Invites You To Join Our Special Sailing
February 4, 1987

CRUISE

The TREASU[illegible] ORIENT & JAVA SEAS

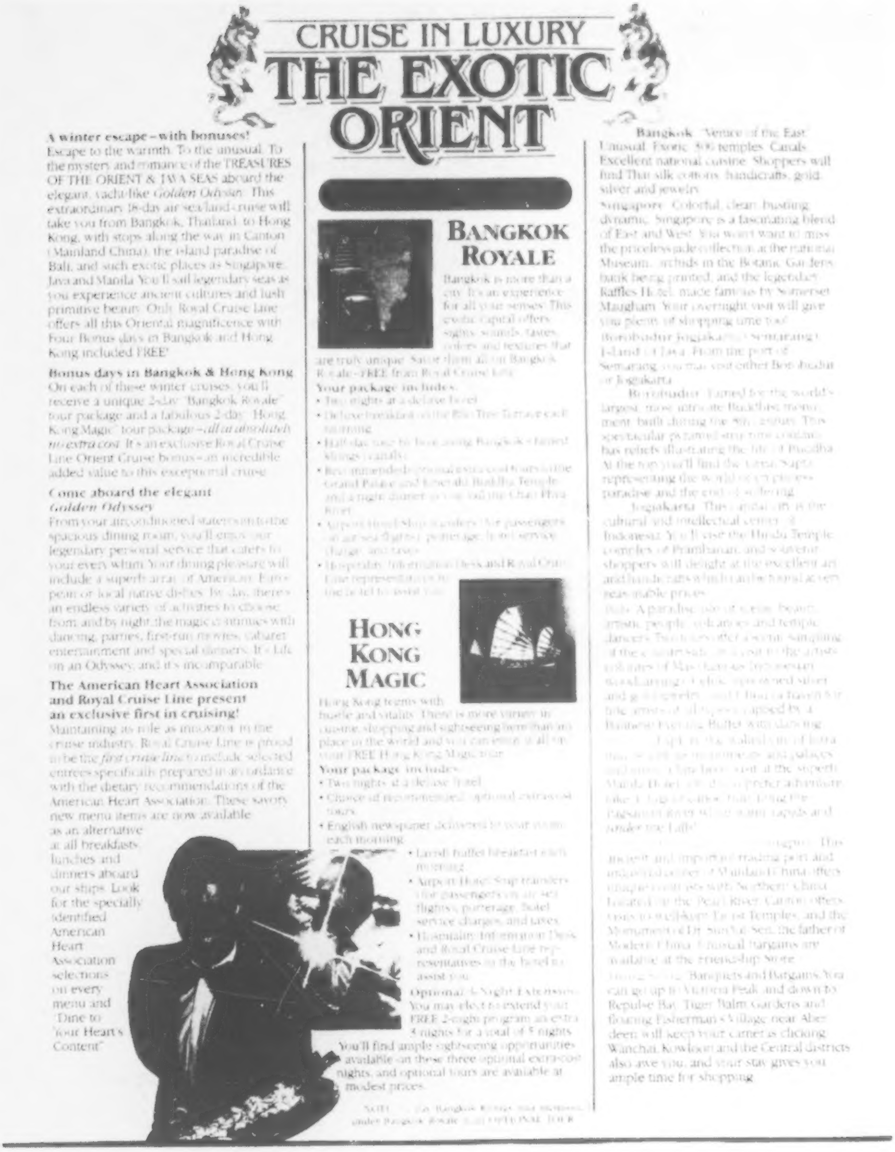
18 DAYS AIR•SEA•LAND

INCLUDING:

Aboard the Elegant Golden Odyssey

Royal Cruise Line

INDIANA UNIVERSITY ALUMNI ASSOCIATION
1854
Hong Kong
Manila
PHILIPPINES
MALAYSIA
SINGAPORE
INDONESIA
JAVA SEA
Bali
CELEBES ISLANDS



CRUISE IN LUXURY
THE EXOTIC ORIENT

A winter escape—with bonuses!
Escape to the warmth. To the unusual. To the mystery and romance of the TREASURES OF THE ORIENT & JAVA SEAS aboard the elegant, yacht-like *Golden Odyssey*. This extraordinary 18-day air/sea/land cruise will take you from Bangkok, Thailand, to Hong Kong, with stops along the way in Canton (Mainland China), the island paradise of Bali, and such exotic places as Singapore, Java and Manila. You'll sail legendary seas as you experience ancient cultures and lush primitive beauty. Only Royal Cruise Line offers all this Oriental magnificence with Four Bonus days in Bangkok and Hong Kong included FREE!

Bonus days in Bangkok & Hong Kong
On each of these winter cruises, you'll receive a unique 2-day "Bangkok Royale" tour package and a fabulous 2-day "Hong Kong Magic" tour package—*all at absolutely no extra cost*. It's an exclusive Royal Cruise Line Orient Cruise bonus—an incredible added value to this exceptional cruise.

Come aboard the elegant *Golden Odyssey*
From your airconditioned stateroom to the spacious dining room, you'll enjoy our legendary personal service that caters to your every whim. Your dining pleasure will include a superb array of American, European or local native dishes. By day, there's an endless variety of activities to choose from, and by night, the magic continues with dancing, parties, first-run movies, cabaret entertainment and special dinners. It's Life on an Odyssey, and it's incomparable.

The American Heart Association and Royal Cruise Line present an exclusive first in cruising!
Maintaining its role as innovator in the cruise industry, Royal Cruise Line is proud to be the *first cruise line* to include selected entrees specifically prepared in accordance with the dietary recommendations of the American Heart Association. These savory new menu items are now available as an alternative at all breakfasts, lunches and dinners aboard our ships. Look for the specially identified American Heart Association selections on every menu and "Dine to Your Heart's Content."

BANGKOK ROYALE

Bangkok is more than a city. It's an experience for all your senses! This exotic capital offers sights, sounds, tastes, colors and textures that are truly unique. Savor them all on Bangkok Royale—FREE from Royal Cruise Line!

Your package includes:
- Two nights at a deluxe hotel
- Deluxe breakfast on the [illegible] Terrace each morning
- Half-day tour by boat seeing Bangkok's famed klongs (canals)
- Recommended optional extra-cost tours to the Grand Palace and Emerald Buddha Temple and a night dinner cruise on the Chao Phya River
- Airport/Hotel/Ship transfers (for passengers on air/sea flights), porterage, hotel service charges, and taxes
- Hospitality Information Desk and Royal Cruise Line representatives in the hotel to assist you

HONG KONG MAGIC

Hong Kong teems with hustle and vitality. There is more variety in cuisine, shopping and sightseeing here than any place in the world and you can enjoy it all on your FREE Hong Kong Magic tour.

Your package includes:
- Two nights at a deluxe hotel
- Choice of recommended optional extra-cost tours
- English newspaper delivered to your room each morning
- Lavish buffet breakfast each morning
- Airport/Hotel/Ship transfers (for passengers on air/sea flights), porterage, hotel service charges, and taxes
- Hospitality Information Desk and Royal Cruise Line representatives in the hotel to assist you

Optional 3-Night Extension: You may elect to extend your FREE 2-night program an extra 3 nights for a total of 5 nights. You'll find ample sightseeing opportunities available on these three optional extra-cost nights, and optional tours are available at modest prices.

NOTE: [illegible] Bangkok Royale [illegible] under Bangkok Royale [illegible] OPTIONAL TOUR

Bangkok: "Venice of the East." Unusual. Exotic. 300 temples. Canals. Excellent national cuisine. Shoppers will find Thai silk, cottons, handicrafts, gold, silver and jewelry.

Singapore: Colorful, clean, bustling, dynamic. Singapore is a fascinating blend of East and West. You won't want to miss the priceless jade collection at the National Museum, orchids in the Botanic Gardens, batik being printed, and the legendary Raffles Hotel, made famous by Somerset Maugham. Your overnight visit will give you plenty of shopping time too!

Borobudur/Jogjakarta (Semarang), Island of Java: From the port of Semarang, you may visit either Borobudur or Jogjakarta.

Borobudur: Famed for the world's largest, most intricate Buddhist monument, built during the 9th century. This spectacular pyramid-shaped stone complex has reliefs illustrating the life of Buddha. At the top you'll find the Great Stupa representing the world of complete paradise and the end of suffering.

Jogjakarta: This capital city is the cultural and intellectual center of Indonesia. You'll visit the Hindu Temple complex of Prambanan, and souvenir shoppers will delight at the excellent art and handicrafts which can be found at very reasonable prices.

Bali: A paradise isle of scenic beauty, artistic people, volcanoes and temple dancers. Tours offer a scenic sampling of the countryside and a visit to the artists' colonies of Mas (famous for Indonesian woodcarvings), Celuk (renowned silver and gold jewelry) and Ubud (a haven for fine artists of all types), capped by a Balinese Evening Buffet with dancing.

[illegible] Explore the walled city of Intramuros, [illegible] monuments and palaces and enjoy a luncheon at the superb Manila Hotel. Or, if you prefer adventure, take a trip by canoe shooting the Pagsanjan River white water rapids and under the falls!

[illegible] This ancient and important trading port and industrial center of Mainland China offers unique contrasts with Northern China. Located on the Pearl River, Canton offers visits to well-known Taoist Temples, and the Monument of Dr. Sun Yat-Sen, the father of Modern China. Unusual bargains are available at the Friendship Store.

Hong Kong: Banquets and Bargains. You can go up to Victoria Peak and down to Repulse Bay. Tiger Balm Gardens and floating Fisherman's Village near Aberdeen will keep your camera clicking. Wanchai, Kowloon and the Central districts also awe you, and your stay gives you ample time for shopping.

Bali's legendary Temple Dancers
The famous floating restaurants of Aberdeen in Hong Kong
The mysteries of Borobudur
JUMBO
Fabulous shrines of Indonesia
The legendary Raffles Hotel of Singapore
Canton's Sun Yat-Sen Memorial Hall

There Is No Vacation Value Like a Royal Cruise Line Air/Sea Cruise.

Here's what is included:

AIR TRANSPORTATION: Air/Sea passengers are provided roundtrip flights via scheduled airlines on Apex and other reduced fares.

CHECK-IN ASSISTANCE: RCL staff will assist air/sea passengers with check in at most major gateways for transpacific and transatlantic flights.

ESCORTED FLIGHTS: RCL Escorts accompany air/sea passengers on most transpacific and transatlantic flights.

FREE BAGGAGE ALLOWANCE: Air/Sea passengers are not restricted by weight. Passengers may bring two large suitcases plus hand luggage that will fit under an aircraft seat.

SERVICE & TRANSFERS: All air/sea passengers (and independent passengers arriving on the same flights) are met by RCL staff and TAKEN DIRECTLY TO SHIP OR HOTEL. Luggage gratuities and airport taxes are included on Trans-oceanic flights.

DINING: Three delicious meals daily featuring Continental and American specialties are included aboard ship. In addition you'll enjoy special buffets, midnight snacks and free 24-hour room service.

CREW: Our warm, caring and efficient Greek Stewards will cater to your every need in your staterooms, the dining room, bars and on deck.

CRUISE STAFF: Our cruise director and his staff are ready to assist you with all your special needs, sightseeing and shore excursions.

LECTURES: On all cruises, you will be invited to interesting and informative lectures on the culture, history, sightseeing and shopping of each port visited.

SPECIAL EVENTS: You will be invited guests of RCL at the Captain's Cocktail party and Gala Farewell Dinner in addition to many other special events and festivities.

SHORE EXCURSIONS: Royal Cruise Line offers a variety of optional shore excursions which may be purchased in advance or on board. Passengers wishing to sightsee on their own also will be assisted in every way.

ON-BOARD ENTERTAINMENT: Every night aboard ship a special show will be presented including passenger participation nights and Greek night.

SPECIAL ACTIVITIES: Exercise classes, dance classes, Greek dancing, fitness center, sauna, walkathon, bridge tournaments, deck tennis, ping pong and other activities are all FREE.

NO REGIMENTATION: You may participate in as many activities as you wish, or none; it is up to you.

YOUR ITINERARY DEPARTING FEBRUARY 4, 1987

Date	Port	Arrive	Depart
Air Flight			
4 Feb	U.S. Departure		Late Evening
5	Cross International Date Line		
Pre-Cruise "Bangkok Royale"			
6	Bangkok (Hotel)	Evening	
7	Bangkok		
8	Bangkok		Early Morning
8	Air Flight to Singapore		
8	Singapore	Morning	
Ship Schedule			
8	Singapore	Afternoon (Board Ship)	
9	Singapore		Afternoon
10	*Cruise the Java Sea*		
11	Semarang	Early Morning	Evening
12	Bali (Padang Bay)	Early Evening	
13	Bali		Early Evening
14	*Cruise the Bali Sea and Makassar Strait*		
15	*Cruise the Celebes Sea*		
16	*Cruise the Sulu Sea*		
17	Manila	Early Morning	Afternoon
18	*Cruise the South China Sea*		
19	Whampoa/Canton	Afternoon	Evening
20	Hong Kong	Early Morning (Disembark)	
Post-Cruise "Hong Kong Magic"			
20	Hong Kong (Hotel)		
21	Hong Kong		
Air Flight			
22	Hong Kong		Afternoon
22	U.S. Return	Evening	

THE INDIANA UNIVERSITY ALUMNI ASSOCIATION

Special Bonus Amenities:

- ★ Special Discount Fares
- ★ $150 Bar/Boutique Credit
- ★ Souvenir Name Badges
- ★ A "Get Acquainted" Bloody Mary Cocktail Party
- ★ An Exclusive Alumni Cocktail Reception on board
- ★ One Group Photograph per couple

COMPLETE AIR•SEA CRUISE PACKAGE FROM INDIANAPOLIS

Stateroom Category	Type of Accommodations	Per Person: Regular Published Fares	Per Person: Indiana Univ. Discount Fares
1 Superior Deluxe	Suite Riviera Deck Amidships/bedroom-sitting area/picture windows/tub/shower	$6308 ✓	$5808
2 Superior Deluxe	Outside Stateroom/Marina and Riviera Decks Amidships/picture windows/tub/shower	5908 ✓	5448
3 Deluxe	Outside Stateroom/Marina Deck Amidships/picture windows/shower	5608 ✓	5178
4 Superior Deluxe	Outside Stateroom/Laguna Deck Amidships/portholes/tub/shower	5258	4863
5 Deluxe	Outside Stateroom/Marina Deck/picture window/shower	5008	4638
6 Deluxe	Outside Stateroom/Laguna Deck Amidships/portholes/shower	4758	4413
7 Superior Deluxe	Outside Stateroom/Coral Deck Amidships/portholes/tub/shower	4608	4278
8 Deluxe	Outside Stateroom/Laguna Deck/portholes/shower	4308	4008
9 Deluxe	Outside Stateroom/Coral Deck Admidships/portholes/shower	4108	3828
10 Deluxe	Inside Stateroom/Marina Deck/shower	4058	3783
11 Deluxe	Inside Stateroom/Laguna Deck/shower	3958	3693
12 Deluxe	Inside Stateroom/Coral Deck/shower	3858 ✓	3603

All fares are per person, double occupancy. Single supplement: **$800** (Categories 10-12). **$500** (Categories 6-9). 3rd or 4th person: Regular: **$3785**. Indiana Univ.: **$3536**. Port Charges: **$80**. Deposit: **$400** per person. Shore Excursions additional.

Subtract $20 for Air/Sea Package From Chicago

ROYAL CRUISE LINE•AIR/SEA FEATURES

YOUR FLIGHTS

You'll board your regularly scheduled airline flight and fly directly to your destination. During your flights, you'll enjoy complete meal and cocktail service. Your return flight is equally as pleasant and comfortable.

YOUR LUGGAGE

Two pieces of check-in luggage per person, plus carry-on bags! More than adequate allowance for your cruise clothes and those special shopping treasures.

TRANSFERS, TAXES AND TIPS

You will be met at the airport and transferred to and from your *Odyssey*. Your luggage will be delivered directly to your stateroom. U.S. and foreign airport taxes are included, as well as tips for luggage handling once you've checked in for your final flight.

SHORE EXCURSIONS

Shore excursions at all appropriate ports of call will be available at an additional cost aboard ship or in an advance purchase package.

CONDITIONS: Royal Cruise Line (U.S.A.), Inc. [RCL USA] acts as suppliers' agent for tours, and is not liable for damages, losses, injury or death resulting from acts, omissions, or negligence of any provider of services or accommodations, or due to other causes beyond the control of RCL USA, and passengers waive claims against RCL USA arising therefrom. RCL USA may refuse passage to anyone at any time, with proportionate refund for unused services or accommodations, and may substitute itineraries, comparable services or accommodations for causes that RCL USA can't control, or for passenger well being; this may be done without refund. RCL USA may increase prices prior to departure due to increases in suppliers' prices, or currency exchange rate changes.

CANCELLATIONS received in writing 60 or more days before departure will result in full refund, otherwise the cancellation charge per passenger will be $200 for cancellations 30 to 60 days prior, and 50% of tour price for cancellations 0 to 30 days prior. Resale of cancelled space in the same category will reduce such charges to $100 per person plus any airline penalty. No refunds will be made for passenger's nonuse of services or accommodations.

AIR TRANSPORTATION on charters may be substituted for scheduled flights or vice versa, and routings may be changed by RCL USA. Transportation to and from departure cities, and schedulings or routings made by passengers, travel agents or airlines are not the responsibility of RCL USA.

BAGGAGE check-in allowance per passenger is two pieces each with no weight restriction, but with maximum aggregate length, width and height dimensions of 62", and 107" for both pieces combined. Carry-on bag(s) must fit beneath one aircraft seat, and be a maximum length, width and height of 45". RCL USA is not responsible for baggage loss, theft or damage.

DOCUMENTS: U.S. Citizens need only have a U.S. Passport valid until 6 months after the cruise termination date. Other nationalities contact Royal Cruise Line.

REGISTRY of the Golden Odyssey is Greece.

CRUISE PORTIONS OF FARES are guaranteed at the published rates in effect at the time of receipt of deposits.

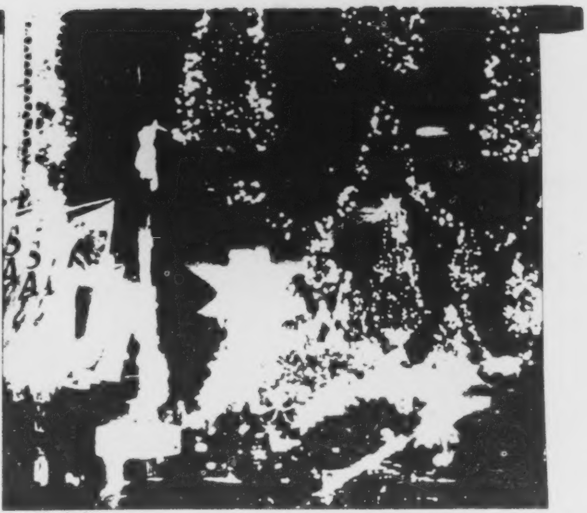
DEPOSIT & FINAL PAYMENT: A $400 per person deposit confirms reservations and indicates the passenger's acceptance of the Conditions and Terms of this brochure. Final payment is due 60 days prior to departure. The Crown Card, Master and Visa Cards are accepted. RCL USA is responsible for passenger's funds only if payment is by check payable to RCL USA.

[illegible] by The Indiana University Alumni Association
[illegible] 23, 1986 to January 1, 1987

CHRISTMAS IN SCOTLAND

◆ THE ITINERARY ◆

Caroling at Christmas, London
Cover: England's Father Christmas



Regent Street, London

USA/Edinburgh
Monday, December 22 – Depart U.S. gateway via regularly scheduled wide-body jet service to *Edinburgh, Scotland*.

Edinburgh
Tuesday, December 23 – Arrive Edinburgh where a Gohagan & Company travel director will meet and assist you with the transfer to the *George Hotel*. The delightful sound of bagpipes will greet you for the four-night stay here. Relax in the afternoon and join fellow alumni at the welcome cocktail party in the hotel tonight.

Edinburgh
Wednesday, December 24 – Enjoy a hearty Scottish breakfast today and each morning of your stay in Scotland. Then spend the morning as you please. Shop for last-minute *Christmas* presents, perhaps choosing fine plaid woolens, aged scotch whiskey or delicious locally-made shortbread. Try curling or skating at *Murray Field*, or attend a traditional holiday pantomime at the *King's Theater*. In the afternoon an included sightseeing tour of Edinburgh shows you the historic *Royal Mile* and fortified castle, the neo-classical architecture of the *New Town* and beautiful holiday decorations. Tonight, a special *Christmas Eve* dinner with musical entertainment and dancing is planned. If you wish, attend midnight services at *St. Giles Anglican Cathedral* and return to the hotel for traditional minced pie.

Edinburgh
Thursday, December 25 – Merry Christmas! Relax or attend services this morning, then meet fellow alumni for a *Yuletide* buffet lunch. *Father Christmas* will visit sometime today, and the *Queen* will deliver her traditional Christmas message in the afternoon. After sunset, a candlelight dinner-dance completes a very special Christmas in Scotland.

Edinburgh
Friday, December 26 – This is *Boxing Day*, the British holiday on which servants were traditionally given Christmas boxes. Tour the lovely Scottish countryside today, perhaps catching a glimpse of an annual Boxing Day fox hunt. En route enjoy lunch in a typical Scottish pub. Then return to the George Hotel for a traditional Boxing Day dinner in the evening.

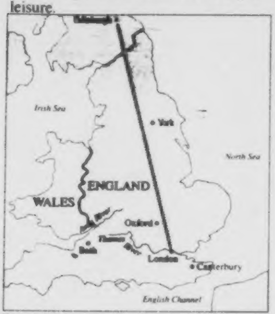
Edinburgh/London
Saturday, December 27 – After breakfast, board the *Flying Scot* train and travel in first class comfort through the wintry countryside to *London, England*.

Hotels

George Hotel, Edinburgh – The George Hotel is one of the premier hotels of Edinburgh and situated in the midst of the city's shopping and attractions. Beautifully decorated for the season, the George will be the focal point of the Christmas festivities. From the gracious entryway which reflects the original 18th-century style to the rooms in the modern wing, the entire complex is tastefully decorated. Two elegant restaurants and lounges are also part of the hotel.

Below: Edinburgh Castle

arriving mid-afternoon. Transfer to London's *May Fair Hotel* for a five-night stay, and spend the balance of the day at leisure.



London

Sunday, December 28 – An included English breakfast starts each day while you are in London. Today's included tour of the city's *West End* features the *Houses of Parliament, Big Ben,* and *Trafalgar Square*. In the afternoon, participate in the optional excursion to *Windsor Castle*, or visit the *Churchill War Rooms*.

London

Monday, December 29 – Pursue your own interests during this free day. Ride a red double-deck bus, shop for post-Christmas bargains at *Harrods* and London's other famous stores, or consult the Gohagan & Company hospitality desk staff for information on the special events scheduled by the *Dickens' House Museum* during the Christmas period.

London

Tuesday, December 30 – Find a cozy pub, take in a play, wander through a museum or see the changing of the guard as you continue to discover London on your own today.

London

Wednesday, December 31 – Spend one final day of leisure today. But whatever your plans, don't miss the farewell party and *New Year's Eve* celebration at the May Fair Hotel tonight.

London/USA

Thursday, January 1 – Happy New Year! After breakfast, transfer from the hotel to the airport for the return flight to the U.S.

Edinburgh – The cultural capital of *Scotland, Edinburgh* hosts holiday travelers with a distinctive charm. View lovely examples of the neo-classical architecture on the elegant crescents and squares, and discover the exquisite collections of the many national museums and art galleries of Edinburgh. Shop along the beautifully decorated *Princes Street* for last minute *Christmas* gifts. Walk along the cobbled *Royal Mile*, the lifeline of the *Old Town* built on an extinct volcanic mound. See 16th-century *Holyrood Palace*, associated with *Mary Queen of Scots*, and pass unusual medieval skyscrapers of more than ten stories. Attend Christmas services in *St. Giles Cathedral*, church of reformer *John Knox*, and explore the city's breathtaking castle, bounded by steep cliff walls. Marvel at the views of Edinburgh from the castle's broad esplanade and see the crown jewels. Then venture into the 18th-century *New Town*, situated on a plain below the castle. The diverse attractions and holiday decorations of this historic capital are a wonderful environment for a Scottish Christmas celebration.

London – Bisected by the *Thames River, London* is an exciting world port which offers a wealth of entertainment. Discover the distinctive flavor of the different boroughs of the city by shopping in fashionable *Mayfair*, sampling the varied foods at the restaurants of *Soho*, or admiring the stately architecture of *Whitehall, Parliament* and *Big Ben*. See the pageantry of the changing of the guard at *Buckingham Palace*, or listen as the *Beefeater guards* at the *Tower of London* relate the long and grisly history of this ancient fortress. When you need a rest, enter a pub for a snack and refreshing glass of ale, or take tea in a lovely parlor. Reserve an afternoon or evening to attend a production in the theater district, and visit the staggering collections of the *National Gallery* and the *British Museum* to see the treasures of imperial Britain. Enjoy the quiet repose of massive *St. Paul's Cathedral*, or wander in the many parks of the city, perhaps pausing to listen to an orator expound on the subject of his choice at the *Speaker's Corner of Hyde Park*. London is a very special city, better enjoyed with each successive visit.

Included Features

- Scheduled air transportation from U.S. gateway to Edinburgh with return from London.
- Four nights' accommodations at the George Hotel, Edinburgh.
- Welcome alumni cocktail party in Edinburgh.
- Scottish breakfast each morning in Edinburgh.
- Sightseeing excursion of Edinburgh.
- Christmas Eve dinner and dancing, Christmas Day Yuletide buffet and candlelight dinner.
- Tour of Scottish countryside on Boxing Day with lunch and a traditional Boxing Day dinner.
- First class train travel from Edinburgh to London.
- Five nights' accommodations at the May Fair Hotel, London.
- English breakfast each day while in London.
- Sightseeing tour of London.
- Farewell and New Year's Eve party.
- Hospitality desks in the hotels, staffed by Gohagan & Company personnel.
- Gohagan and Company travel director to assist you throughout the trip.
- Airport taxes, hotel and included meal service charges.
- All transfers and luggage handling between European airports, train stations and hotels.
- Alumni flightbag, name badge and passport wallet with trip information sent to each participant's home in advance of departure.

Below: Hunt Meet

May Fair Hotel-London – When the May Fair Hotel opened its doors in 1827, King George V paid it the ultimate compliment when he said, "No more fitting site could have been chosen for the creation of an ideal hotel." Located in the West End, the May Fair Hotel is less than a half-mile from Buckingham Palace and conveniently located for shopping along Bond Street. It houses the May Fair Theater as well as its own cinema and its Le Chateaubriand dining room is known for fine French cuisine. Each of its guest rooms has color television with in-house movies, a mini-bar and direct dial telephone service. The May Fair Hotel is an Inter-Continental Hotel.

First-Class Trains

If you have not traveled by train in Scotland and England, you are in for an exciting experience – an experience that is clean, safe, fast, and comfortable. These trains do not dally; they typically cruise at high speeds. Your travel time between Edinburgh and London takes approximately 5 hours. En route, relax in the heated cars while you pass through the countryside where the television series "Brideshead Revisited" was filmed.

Indiana University

Dear IU Alumni:

We are pleased to offer you an opportunity to join fellow alumni in celebrating *Christmas* in *Edinburgh, Scotland*.

This 10-day program through *Britain* begins with four nights in the charming medieval city of Edinburgh. From the choir and pageantry of Christmas morning services in beautiful *St. Giles Cathedral* to traditional Scottish Christmas foods and festivities, you'll experience the warmth of this special holiday season.

Then travel in first-class comfort on the *Flying Scot*, one of the quickest land connections to *London*. Spend five nights in the heart of the city. Tour the sights, attend a theatrical performance, visit the magnificent museums or shop the post-Christmas sales, before welcoming in the new year.

There will be time for caroling, exploring and simply enjoying the ambiance of British holiday attractions. The accommodations are centrally located and among each city's finest. A Gohagan & Company travel director will be along throughout the trip to take care of all those travel details for you.

Spend the coming holiday season with your family and in the company of alumni as you celebrate Christmas in Edinburgh and herald in the *New Year* in London. It's sure to be a Christmas you won't soon forget. Send your deposit today.

Sincerely,

Frank B. Jones

Frank B. Jones
Executive Secretary
University Director of Alumni Affairs

CHRISTMAS IN SCOTLAND *Reservation Form*

$2595 per person from Chicago (based on double occupancy).

Send to: IUAA Educational Tours
Alumni Association
IMU/M-17
Bloomington, IN 47405
812/335-6030

I am requesting ________ reservation(s), and have enclosed my check for $ __________ as deposit ($500 per person). Make checks payable to **1986 Christmas in Scotland.**

Name(s)

First *Initial* *Last* *Class Year*

First *Initial* *Last* *Class Year*

Address

City *State* *Zip Code*

Telephone ( ) *(Home)* ( ) *(Office)*

Preferred name(s) for name badge(s)

☐ I prefer single occupancy at an additional cost of $225. (Singles are limited.)
☐ I am reserving as a single but wish to share accommodations (shares cannot be guaranteed).

☐ I/we prefer non-smoking section whenever possible.
☐ Smoking preferred.

I/we prefer to depart from:
☐ Chicago.
☐ Reserve space for me/us to connect with the transatlantic flight in Chicago from:

City of Departure

Note: Reservations for connecting flights will be made at the lowest available air fare and the cost will be reflected in your final billing.

TRIP PRICE TO BE PAID IN FULL BY OCTOBER 23, 1986.

General Information

Not Included: Personal expenses such as laundry, telephone calls, alcoholic beverages, meals not listed in the "Included Features," passport fees, U.S. customs taxes, optional sightseeing excursions, accident and baggage insurance and gratuities.

Health: Any physical or mental conditions which may require special medical attention, for example, the need for a wheelchair must be reported in writing when your reservation is made.

Cancellations and Refunds: Should you have to cancel your trip, the following terms will apply: Cancellations will not be effective until they are received in writing in the offices of Gohagan & Company. All cancellations are subject to a nonrefundable $35-per-person administrative charge. Full refund of all payments, less the $35, will be made for accommodations cancelled up to and including 91 days before departure. Later cancellations will be subject to the following charges: 61 to 90 days prior to departure, 20% of trip price; 31 to 60 days prior to departure, 35% of trip price; 16 to 30 days prior to departure, 60% of trip price; 1 to 15 days prior to departure, 90% of trip price. Cancellations within 24 hours of departure, or a no-show, will result in forfeiture of 100% of the tour cost. An early return from the program will result in forfeiture of the entire tour cost. These cancellation fees are for the tour package, and are in addition to any applicable cancellation fees for the airlines.

Air Transportation Conditions and Changes: Airline pricing policies require a $100-per-person fee if your reservation is changed or cancelled within 21 days of departure. This trip price is based on a special economy class fare. Changes in airline reservations after departure will result in higher air fares. Participating airlines are all IATA and ARC member carriers.

Since these cancellation policies are strictly enforced, for your protection, we strongly recommend that you purchase trip cancellation insurance. We will send you an application after you reserve.

Responsibility: Thomas P. Gohagan & Company and the sponsoring association act only as agents for the passenger with respect to travel services. We can assume no responsibility nor liability in whole or in part for any delays, delayed departure or arrival, missed carrier connections, loss, damage or injury to person or property or mechanical defect, failure, or negligence of any nature howsoever caused in connection with any accommodations, transportation or other services or for any substitution of hotels or of common carrier equipment beyond our control, with or without notice, or for any additional expenses occasioned thereby. Baggage is at the owner's risk throughout the tour, unless insured.

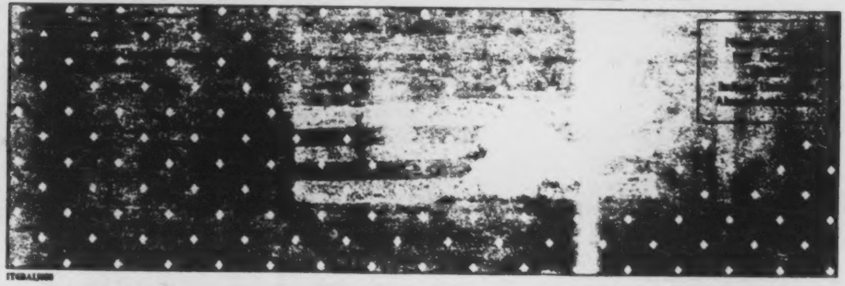
The right is reserved to decline to accept or retain any person as a member of these tours at any time.

No revision of the printed itinerary or the "Included Features" is anticipated, however the right is reserved to make any changes, with or without notice, that might become necessary, with the mutual understanding that any additional expenses will be paid by the individual passenger.

The airlines and other transportation companies concerned are not to be held responsible for any act, omission, or event, during the time passengers are not on board their conveyances. The passage contract in use when issued, shall constitute the sole contract between the companies and the purchaser of these tours and/or passenger.

Rates: Prices quoted are based on June, 1986, tariffs, rates of exchange and fuel prices, and are subject to change thereto at or before the time of tour departure.

Travel arrangements by:
Thomas P. Gohagan & Company
A service of Alumni Travel and Alumni Colleges Abroad
224 South Michigan Avenue
Chicago, Illinois 60604
(312) 922-3002



IT6BAL/000

ALL ABOUT TRAVEL
A COMPLETE TRAVEL SERVICE
(818) 962-8995
632 SO. SUNSET AVE., WEST COVINA, CA 91790

25 May, 1987

Dr. Robert Schuller,
Garden Grove,CA.,

Dear Dr.Schuller:

I was disappointed to pick up the latest copy of POSSIBILITIES, and see the ad on the back cover. I was especially disappointed to read the words, "Not available through Travel Agents."

My wife is one of the supporters of your television ministry. On this basis I feel that I have a justifiable reason for resenting this "biting the hand that feeds you" policy.

On the one hand you appeal for help from business persons like us. Then with the other hand you take money out of our pockets by carrying on travel programs that are in direct competition with legitimate travel agencies. I'm sure there are many other travel agents, as well as the AMERICAN SOCIETY OF TRAVEL AGENTS, who feel just as I do. I am sending a copy of the ad to the above named organization.

I am appreciative of the good your television ministry does,but I do not appreciate your using your tax exempt status to enter into hurtful competition with private business like mine. I'm sure you are aware that Congress is currently taking a long look at this very situation.

I would hope that you will give honest consideration to the above.

Sincerely,

Wendell Wellman

Wendell Wellman,CTC
Owner, ALL ABOUT TRAVEL

TRADITIONAL
American
VALUES

For a while it appeared as though many basic American beliefs had become obsolete. Beliefs like the family, home, God and country.

Now the pendulum is swinging back, and millions of Americans are rediscovering these basic principles in the pages of *The Saturday Evening Post.*

Each issue of the *Post* contains inspirational interviews and articles that will

revive your optimism and faith in the basic goodness and decency of America.

The *Post* cares enough to publish positive articles about such great Christian leaders as Robert Schuller, Norman Vincent Peale, Pat Robertson and many others.

We are also concerned

T_ SATURDAY
VENING POST

©1986 SatEvePost

about your health and the health of your family and friends. We're committed to providing you with the latest in preventive medical information.

And, of course, you'll find all the regular features that millions of readers have come to enjoy through the years . . . relaxing, entertaining fiction, good humor, delightful and tasteful cartoons, fascinating stories—truly a magazine for your entire family that you can proudly display in your home.

Subscribe now and have America delivered to your door for just $12.97 a year (9 issues), a 26% savings off the single copy price of $17.55.

The Saturday Evening Post Society
P.O. Box 10675 • Des Moines, IA 50336

☐ **1 Year—*$12.97*** ☐ **2 Years—*$23.97*** ☐ **3 Years—*$32.97***

☐ Payment enclosed ☐ Bill me ☐ VISA ☐ MasterCard

Credit card no. __________

Expiration Date __________

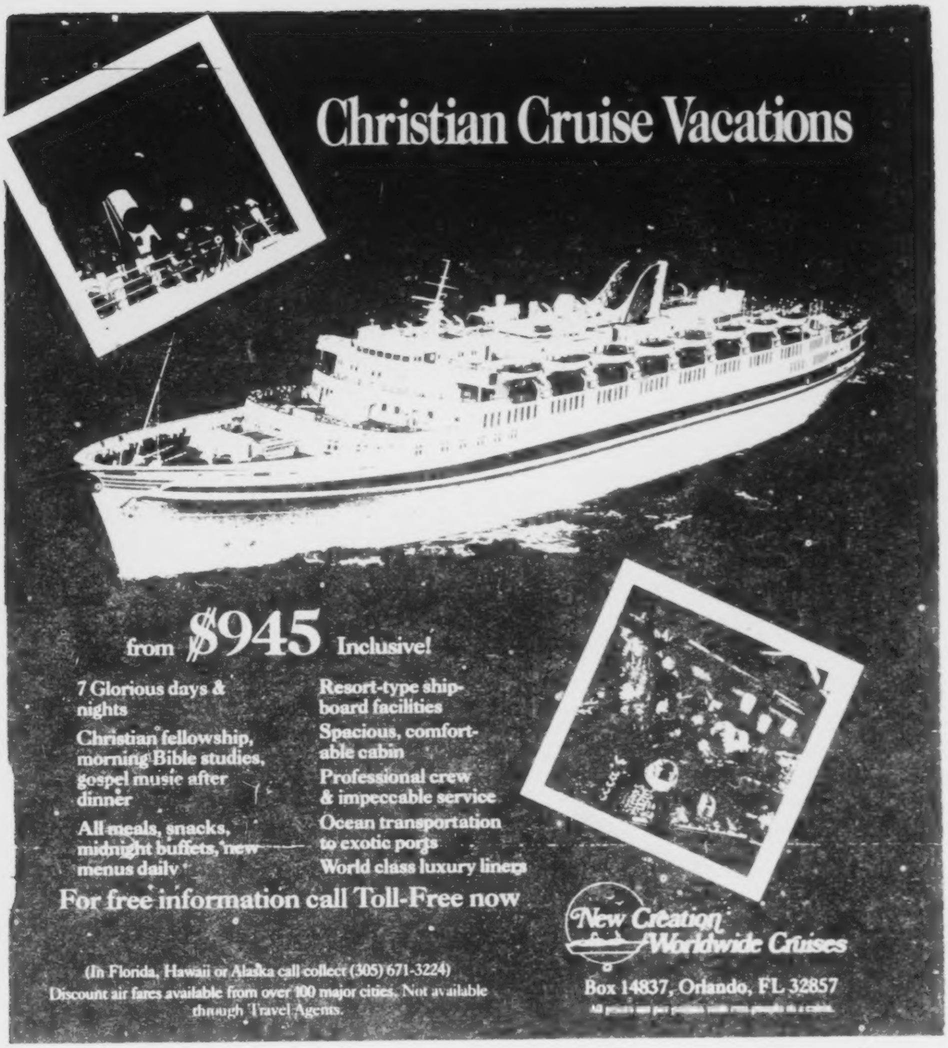
Signature __________

Name __________

Address __________

City __________

State __________ Zip __________ 48004



Christian Cruise Vacations

from **$945** Inclusive!

- 7 Glorious days & nights
- Christian fellowship, morning Bible studies, gospel music after dinner
- All meals, snacks, midnight buffets, new menus daily
- Resort-type shipboard facilities
- Spacious, comfortable cabin
- Professional crew & impeccable service
- Ocean transportation to exotic ports
- World class luxury liners

For free information call Toll-Free now

(In Florida, Hawaii or Alaska call collect (305) 671-3224)
Discount air fares available from over 100 major cities. Not available through Travel Agents.

New Creation Worldwide Cruises
Box 14837, Orlando, FL 32857
All prices are per person with two people in a cabin.

Robert Schuller Ministries
Box 100
Garden Grove, CA 92642

[illegible]
PAID
[illegible] Ministries

Vacations — You Can't Afford To Miss! . . .

1986 PRICES FOR
1987 VACATIONS

GREAT NEWS!!!

Passionist Monastery
5700 North Harlem Avenue
Chicago, Illinois 60631
ADDRESS CORRECTION REQUESTED

NON-PROFIT
ORGANIZATION
U.S. POSTAGE
PAID
Passionist Community
Permit [illegible]
Chicago, Illinois [illegible]

About your tour director...

Back in college days, Father Godfrey Poage, C.P. found writing much easier than manual labor. For summer work he did feature articles for his hometown paper, the Des Moines' REGISTER & TRIBUNE. The success he achieved in this secular field encouraged him to later develop religious topics. To date he has published 22 books and pamphlets, two of the latter, FOLLOW ME and FOLLOW HIM having sold over a million copies each.

The first eleven years of his priesthood were spent on the Passionist Mission band. At the same time he was a regular speaker on the nationally broadcast CATHOLIC HOUR and very active in youth work. Eventually he became National Secretary of the American Vocational Clubs. It was from this post in 1956 that he was called to Rome and named International Secretary of Pontifical Office for Religious Vocations. In 1963, Pope Paul VI promoted him to the Directorship of the same office, and he served in that capacity until the 2nd Synod of Bishops recommended that all future recruitment and training of religious candidates be the responsibility of each national hierarchy. At that time Father Poage asked permission to return to his Congregation, where he now **serves as a Tour Director** and Moderator of their Lay Guild.

PLACE
STAMP
HERE

FATHER GODFREY POAGE, C.P.
PASSIONIST MONASTERY
5700 NORTH HARLEM AVENUE
CHICAGO, ILLINOIS 60631-9985

VACATIONS OF A LIFETIME ....

REAL VALUE . . . STUNNING ACCOMODATIONS . . . EXTRAORDINARY BUDGET PRICES

MAY 2-9, 1987

The best cruise of the "Love Boat" in 1987 will be the one that departs San Juan, Puerto Rico, on May 2nd and returns there May 9th, 1987. That's the one we've chosen for our **SPRING HOLIDAY IN THE CARIBBEAN**, sailing from San Juan to Barbados on the Sun Princess, then on to Mayreau, Martinique, St. Maarten and St. Thomas islands, before returning to San Juan, the land of calypso and steel drums.

MAY 30 - JUNE 14, 1987

In all the world there are no four countries so close together yet so different, as England is from Ireland and Scotland from Wales. To prove the same and afford you a most delightful holiday we offer our **TREASURED ISLES TOUR**, visiting all the shrines and show places of Scotland, England and Wales the first week, and then devoting the second week to the glories of Ireland.

FOR VACATIONERS WHO WANT IT ALL

JULY 25 - AUGUST 5, 1987

GRAND ALASKAN ADVENTURE

On our **GRAND ALASKAN ADVENTURE** we fly you to Vancouver and after sightseeing that spectacular city, you'll board the Pacific Princess to cruise up the Inland Waterway to Skagway, Alaska. There you'll take the famed narrow-guage railway to Whitehorse, where the summer sun shines 19 out of 24 hours! Following the Yukon Trail you'll visit Fairbanks and have a tour of the Denali Wildlife Park on the way to Anchorage, before flying back to Chicago by way of Seattle.

"FANTASTIC"

IMAGINE A VACATION WHERE YOU CAN COME CLOSER TO GOD.

AUGUST 15 - 30, 1987

MARIAN SHRINES PILGRIMAGE

In late summer our **MARIAN SHRINES PILGRIMAGE** will include Europe's most famous centers of devotion to the Mother of God. We'll visit Fatima in Portugal, Lourdes in France, and Pilar and Montserrat in Spain. This tour not only honors Mary, but also includes the principal wonders and attractons of the Iberian Peninsula.

SEPTEMBER 18-27, 1987

Early Fall is the most colorful time to visit the **HEART OF EUROPE** and on this tour we take you to Munich for the beginning of the famed Oktoberfest, then to Salzburg for its music, Vienna for "Heurigen" ("New Wine" celebration) and Budapest for its Hungarian Goulash Festival. The tour concludes with an alpine holiday in Kitzbuhel, the finest and most spectacular Bavarian resort.

NOVEMBER 7-20, 1987

Our **HOLY LAND PILGRIMAGE** is the most complete tour ever offered in ten days of the country Jesus loved. We include the best of Jordan (Amman and the "lost city" of Petra) plus everything of importance in Judea, Samaria and Galilee. On the way home we stop for three delightful days in Rome with a papal audience.

DECEMBER 26 - JANUARY 8, 1988

Shortly after Christmas we'll have an exciting **EUROPEAN CAPITALS TOUR**, which will include Amsterdam, Brussels, Bonn and Cologne, Luxembourg, Paris and London. In each country we'll include all the local attractions and you'll never find a more exciting place to welcome the New Year than "gay Paree"!

FOR ADDITIONAL INFORMATION

Dear Father Godfrey,

One of your tours really interests me and I'd like further information. The tour I like is checked below:

☐ THE CARIBBEAN CRUISE

☐ THE TREASURED ISLES TOUR

☐ THE GRAND ALASKAN ADVENTURE

☐ THE MARIAN SHRINES PILGRIMAGE

☐ THE HEART OF EUROPE PLUS OKTOBERFEST

☐ THE HOLY LAND PILGRIMAGE & ROME

☐ EUROPEAN CAPITALS TOUR

I CANNOT PARTICIPATE IN 1987. IN THE FUTURE I WOULD LIKE TO VISIT ...

☐ HOLY LAND ☐ POLAND ☐ RUSSIA
☐ IRELAND ☐ SCANDINAVIAN COUNTRIES
☐ ALASKA ☐ PACIFIC ISLES ☐ ORIENT
☐ MEXICO TOURS ☐ CANADA

Name ____________________

Address ____________________

City & State ____________________

Phone: Home ____________________

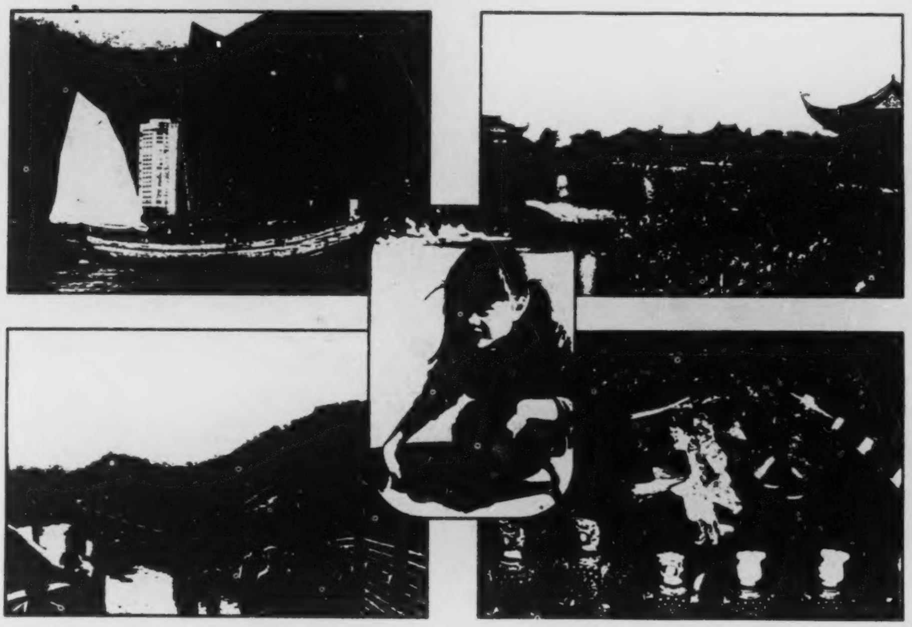
Work ____________________

Date ____________________

THE UNIQUE WONDERS OF

CHINA

Tokyo, Beijing, Xi'an, Shanghai, Wuxi,
Hangzhou, Guilin, Kunming, Guangzhou
plus HONG KONG



The Best of China - 21 days/19 nights
Scheduled Air Transportation... Deluxe/First Class Hotel Accommodations...
All Transfers... Sightseeing... Luggage Handling...
U.S. Tour Director and all meals within China!

FULLY ESCORTED BY A TRAVEL PROFESSIONAL

The Unique Wonders of China

Visit CHINA, the destination of the 80's. Explore the wonders of a 5,000 year old civilization that most Westerners have never seen.

Your Vacation Includes:

- Round trip jet transportation via scheduled carrier with inflight meal, beverage & movie service
- Deluxe/First Class hotel accommodations throughout your entire vacation
- Pre-registration at your hotels
- Complete travel and tourist information mailed to you prior to your departure
- Experienced bi-cultural U.S. tour director
- Full Western Breakfast each morning
- Lunch & Dinner daily within China includes: a Peking Duck Dinner in Beijing, a special Western style Dinner in Shanghai, and a Cantonese Banquet in Canton
- A Gala Farewell Banquet in Hong Kong
- All inter-city transfers
- A hospitality desk hosted by overseas staff who will advise you on local points of interest
- Cruises on the magical West Lake while in Hangzhou; the Grand Canal in Wuxi, and on the Li River in Guilin
- Sightseeing in each city
- Informative briefings on the highlights of each city
- All airport, hotel, train transfers in Japan, China & Hong Kong including tips to porters
- All taxes and service charges for included features
- All visa fees, departure taxes, customs and immigration fees
- Deluxe oversized flight bag
- Convenient passport wallet and name badge
- Complete travel and tourist information mailed to you before departure
- Informative briefings on each city
- The opportunity to purchase a comprehensive travel insurance program

On the Unique Wonders of China, you'll enjoy the most relaxing vacation you've ever experienced because every detail of your trip has been arranged by travel experts. Everything from plane reservations and tickets, to check-ins, and baggage transfers has been taken care of for you. You will also be advised on visa requirements, suitable dress, sightseeing and shopping hints.

**All you have to do is make your reservation…
from that moment on your
vacation will be carefree.**

JAPAN
Tokyo
CHINA
Beijing
Xi'an
Wuxi
Nanjing
Shanghai
Suzhou
Hangzhou
Kunming
Guilin
Guangzhou
Hong Kong

Find happiness in Yu Garden.

Stroll down honeymoon lane in Hangzhou.

AND EACH CITY INCLUD MUCH, MUCH MORE…

TOKYO

You will travel to China in the greatest comfort possible, and enroute we will overnight in Tokyo to allow you to adjust to the time difference.

BEIJING (Peking)

You'll stop in China's glorious capital where you'll visit the Forbidden City. You'll also see the Ming Tombs - the Great Wall and the lovable Pandas at the Beijing Zoo.

- Accommodations at the Great Wall Sheraton
- Full Western breakfast each morning
- Lunch & dinner each day
- A special Peking Duck Dinner
- Visit the Forbidden City, Summer Palace & Temple of Heaven
- Full day excursion to explore the Great Wall of China & Ming Tombs

XI'AN (Shee-an)

Here you'll see the famous "Terra Cotta Army"–6,000 life-size ceramic statues of warriors, horses and chariots who, after 23 centuries, still guard their emperor's tomb.

- First class hotel assigned by CITS
- Air transfer from Beijing to Xi'an
- Full Western breakfast each morning
- Lunch & dinner daily
- Sightseeing of the incredible Terra Cotta Army from the Qin Dynasty

SHANGHAI

Explore the markets, the "Children's Palace" and Yu Fo Si, a white jade buddha.

- Deluxe accommodations at the new Hua Ting Sheraton
- Air transportation from Xi'an to Shanghai
- Full Western breakfast each morning
- Lunch & dinner daily
- A special Western Dinner
- City tour of Shanghai seeing the Bund, the Jade Buddha Temple and more

WUXI (Wooshi)

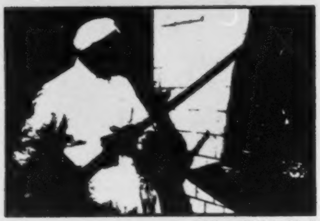
You'll cruise on the Grand Canal in this ancient city in the heart of China's silk region. Another beautiful sight is Lake Tai with its 100 islands and the Mei Garden, full of sweet-smelling plum trees.

- First class hotel assigned by GITS
- Train transportation from Shanghai to Wuxi
- A cruise on the Grand Canal
- Western breakfast each morning
- Lunch & dinner daily

Unique to China—Panda Bears!

You'll visit the "Terra Cotta Army" on your included Tour.

Take a walk in Kunming's Stone Forest.



Master Peking Chef.

HANGZHOU (Hahng-jo)

"I've found paradise on earth," wrote Marco Polo, when he sailed on Hangzhou's beautiful West Lake. You'll take the same cruise, past the lake's four islands with their carved bridges and summerhouses. Hangzhou is the favored spot for a Chinese honeymoon.

- Accommodations at the impressive Hangzhou Hotel
- Train transportation from Wuxi to Hangzhou
- Full Western breakfast each morning
- Lunch & dinner daily
- A full day of sightseeing highlighted by a cruise on magical West Lake

GUILIN (Kway-linn)

The Guilin countryside has inspired China's artists and poets—your cruise on the Li River is like a ride through a Chinese painting. You'll pass Folded Brocade Hill and Reed Flute Cave, with its underground grotto that can hold 1,000 people.

- Accommodations at the Riverside Resort
- Air transportation from Hangzhou to Guilin
- Full Western breakfast each morning
- Lunch & dinner daily
- Cruise on the Li River with its lush panorama

KUNMING (Kun Ming)

Encircled by mountains, Kunming is near the natural wonder of the Stone Forest, an extraordinary panorama of towering rock formations (some as tall as six storeys). Kunming was the one time base for the Flying Tigers and also the terminus of the Burma Road.

- First class hotel accommodations at the Green Lake Hotel
- Air transfer from Guilin to Kunming
- Full Western breakfast, lunch & dinner daily
- Sightseeing of the unique towering rock formations of the Stone Forest and Shi Lin Village, a commune hamlet of the Sani minority people

GUANGZHOU (Canton)

This lovely tropical city, 75 miles from Hong Kong, is the center of commerce between China and the West. The local cuisine is also famous—steamed dumplings filled with meat, sweet paste, or preserves. It's spring year-round here and the city is full of gardens.

- Accommodations at the picturesque White Swan Hotel
- Full Western breakfast each morning
- Lunch & dinner daily
- A special Farewell to China Chinese Banquet featuring Cantonese specialties

HONG KONG

Your vacation concludes on the glittery island of Hong Kong. Here you'll enjoy some of the best duty-free shopping in the world. Explore the markets and curio shops; sample delicious foods from the Orient and the West. Ride up Victoria Peak for the famous view of Hong Kong Harbor. "Red Sails in the Sunset" was written about this sight. Through the mist, you'll catch one more glimpse of China's graceful hills.

- Accommodations at the deluxe Sheraton Hong Kong
- Train transportation from Guangzhou to Hong Kong
- Full Western breakfast each morning
- A Gala Farewell Western Dinner with open bar and hors d'oeuvres
- A panoramic city tour of Hong Kong visiting Aberdeen, Victoria Pearl, and more

The Famous Stanley Market, Hong Kong.

Your Home Away From Home

The Narita Nikko Hotel, Tokyo

First class, 11-story hotel with air conditioning, outdoor pool, sound proof rooms, three restaurants and a lounge, and in-hotel airline check-in facilities.

Great Wall Sheraton, Beijing

Located near the Great Wall, the Forbidden City, and the Summer Palace, the Great Wall offers all the amenities of Western comfort including indoor heated pool, tennis courts, miniature golf, and health club facilities as well as a coffee shop, five restaurants, and lounge.

Hua Ting Sheraton, Shanghai

Just opened in the summer of 1986, the distinctive Hua Ting Sheraton features guest rooms fully equipped with air conditioning, telephone, color television with in-house movies, radio, refrigerator, and mini-bar. The hotel is located just four blocks from the scenic Huangpu riverfront, and is convenient to Shanghai's attractions. The hotel offers recreational facilities such as an indoor swimming pool, gymnasium, sauna, steam room, whirlpool, massage, billiard room, bowling alley, four restaurants, a cafe, several lounges, and a discotheque.

The Hangzhou Hotel, Hangzhou

Formerly the Xiling Hotel, the Hangzhou Hotel is located on lovely West Lake. Managed by the renowned Shangri-La Group, the Hangzhou has been completely renovated for maximum comfort. Guest rooms are spacious and offer scenic lake views.

The Riverside Resort, Guilin

This superior first-class hotel was newly opened, and is superbly situated along the shore of the Li River, surrounded by the mountains of Guilin. The hotel boasts two restaurants, lounge and bar, air conditioning, color television plus many other amenities.

Green Lake Hotel, Kunming

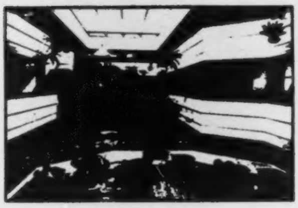
Facing beautiful Green Lake Park, the Green Lake Hotel truly evokes the atmosphere of this "City of Eternal Spring." Each room is tastefully decorated and equipped with radio, television, telephone, and air conditioning. There are two dining rooms offering Western and local Yunnan cuisine. Other facilities include a barber shop, foreign exchange service, and shops.

Green Lake Hotel, Kunming

Great Wall Sheraton, Beijing

The White Swan Hotel, Guangzhou

This deluxe hotel is a dramatic 34 story addition to the scenic Pearl River shores. It boasts a spectacular multi-level atrium with waterfalls and exquisite gardens. Its guest rooms and suites offer spacious luxury. There are swimming and tennis facilities.



The White Swan Hotel, Guangzhou

The Sheraton Hong Kong

This superior first class hotel lies in Hong Kong's lively financial center and is convenient to the city's sights. The Sheraton Hong Kong offers distinctive spacious rooms with every amenity including minibars, color television, telephone, and air conditioning as well as two restaurants featuring Oriental and Continental cuisines, coffee shop, sidewalk cafe, several lounges, and a rooftop garden with a pool and health club.

In Wuxi and Xi'an your hotel is assigned by the China International Travel Service, C.I.T.S. prior to your departure.

Don't Delay—Space is Limited
ONLY 34 SEATS AVAILABLE PER DEPARTURE!

The Unique Wonders of China is the vacation of a lifetime. Don't miss the opportunity to visit areas that others seldom see and to bring home memories that are sure to last a lifetime. This vacation not only offers you a fascinating travel experience but just think of the friends you'll make! To guarantee your place RESERVE NOW—we have scheduled this trip when the climate in China is the most temperate.

NEW JERSEY STATE FEDERATION OF WOMEN'S CLUBS
Mrs. Jerry B. Loizoaux, *President*

55 Clifton Avenue
New Brunswick, New Jersey 08901
Telephone: (201) 249-5474/5485

You are Cordially Invited to Experience the Delights
and the Mysteries of a Land Few Travelers have Seen this Century.
Indeed, a Place Virtually Closed Off to the West for the Last 35 Years.

* * * * CHINA! * * * *

You'll Savor the Hospitality and Special Ambience of Eight
Fascinating Cities From Shanghai to Peking ... Plus the Shopper's
Paradise of Hong Kong. Without Question, the
Travel Adventure of a Lifetime!

AN ALL INCLUSIVE, PROFESSIONALLY GUIDED TOUR
21 Days/19 Nights

Dear Member and Travel Companion:

When you think about it, there's still only one destination in the world whose very name triggers excitement among the most experienced travelers...

...ONE place even the most worldly adventurers, since the days of Marco Polo, have saved for their "someday"...

CHINA - And now it can be yours when you join your fellow members, their families and friends from The New Jersey Federation of Women's Clubs for a unique experience limited to only 34 tour members ... a thrilling odyssey to the Orient's most precious jewel, plus Hong Kong.

China has the longest continuous history of any nation on earth. The Chinese invented the compass, the civil service, papermaking, silk culture and movable type.

Best of all, the arts of China's highly developed culture -- the palaces, the gardens, the exquisite silk scrolls, the ancient statues, the 2,000 year-old Great Wall -- have been preserved for you to see. The shapes of Chinese writing and Chinese porcelain are much the same today as they've been for thousands of years. Other ancient peoples have vanished, but China is one ancient civilization you can see firsthand.

We've included all meals in China plus all sightseeing, special banquets, three cruises and cultural shows in this exciting country which very few Western travelers have seen.

To insure your comfort and peace of mind, every travel detail has been taken care of for you by the experts at Vantage Travel.

After reviewing many travel companies' qualifications, we have entrusted your travel arrangements to the experienced professionals of Vantage Travel Service. With 212 years of expertise, Vantage Travel stands for quality, reliability and experience in arranging and planning group travel.

QUALITY means selecting the best in scheduled airlines, hotels, ships, restaurants and sightseeing. Vantage believes quality also means small group size, which ensures that each tour member receives personalized, attentive service... never feeling hurried or unduly pressured to do what everyone else does.

You'll enjoy making new friends and traveling with people of your own professional and social background and because your destination is so special, it's likely to lead to special bonds of friendship.

RELIABILITY means GUARANTEEING you get what you pay for - scheduled air service on major air carriers, guaranteed pricing, an experienced Tour Director throughout your entire vacation and more. Vantage's many repeat travelers are proof of their reliability.

EXPERIENCE means they carefully design and constantly revamp each of their travel programs based on the ongoing research of their staff members - in this case, thorough on-the-scene "field work" to find the best that China has to offer... so that your experience will be as rewarding as possible.

PLANNING means that every detail is taken care of for you. Vantage sees that all tour members are well briefed with such information as requirements for visas, suitable dress, shopping hints and much more! Because of Vantage's careful planning, the only detail you must attend to is to make your reservation. The experts at Vantage Travel have even made reserving easy and all major credit cards are accepted.

FROM START TO FINISH, YOUR EVERY NEED IS ANTICIPATED
ON THIS ALL-INCLUSIVE VACATION

Before your trip, you'll receive detailed information about China and an oversized travel bag. All of your visas will be arranged. Your vacation includes round trip jet transportation with in-flight meal and beverage service, all intercity transportation, luggage handling and check-ins and first class hotel accommodations.

The small size of your group will also add to the ease and enjoyment of your tour.

A professional bi-cultural Tour Director (minimum fifteen years experience) will accompany you throughout the trip to provide extra assistance and special information. In addition, you'll receive a Welcome Briefing and sightseeing in each city conducted by China's best local guides who know their history and setting - and who are especially anxious to extend a hand of friendship to you.

You will indeed find the Chinese people industrious and friendly. Tourism from the West is one of the most exciting recent developments here and you can be sure of a warm and enthusiastic welcome.

China is a paradise for photographers, shoppers, history buffs and people watchers! You can buy beautiful hand-embroidered silk, watch a master of calligraphy and sample delicate vegetables of every color and size.

Your vacation includes such "Wonders-of-the-World" as the Great Wall and the Stone Forest, plus many special events -- cruises on the Li River, West Lake and the Grand Canal, a visit to the Forbidden City and a sumptuous Farewell Banquet.

Here's just a preview of your itinerary:

TOKYO is your first stop where you will overnight at the first class Narita Nikko Hotel and have a chance to catch up on your sleep and adjust to the time difference.

BEIJING ("Bay jing"), formerly Peking, is the political and cultural center of modern China and is over 3,000 years old. You'll visit the Forbidden City (the emperors' palaces and private courtyards) -- the world's largest existing group of ancient buildings. Other "must-see" attractions which you will record on film or in memory are the Great Wall, the Ming Tombs (with the Sacred Way of stone animals) and the wonderful pandas at the Beijing Zoo.

In XI'AN ("Shee-an"), you'll remember the astonishing news reports of the discovery of the "Terra Cotta Army" -- 6,000 warriors, horses and chariots who've guarded the tomb of the Emperor Qin Shi Huangdi for 2200 years. Seeing first hand the vast burial ground standing at attention, you'll feel as if you've uncovered one of the great secrets of the earth.

SHANGHAI ("Shang hi") Once a small fishing village, Shanghai grew to be one of the largest cities in the world. The Bund (Shanghai's waterfront) hums with activity. You'll be able to explore the markets, visit the Children's Palace and have a "close up" view of master craftsmen carving jade.

WUXI ("Wooshi") You'll cruise on the Grand Canal in this ancient city in the heart of China's silk region. The highlight of your stop will be shopping for finely woven, delicate silk cloth and strolling among the mulberry bushes where the silk worms are raised. Other beautiful sights are Lake Tai with its 100 islands and the Mei Garden, full of 10,000 sweet-smelling plum trees.

HANGZHOU ("Hanng-jo") "I've found paradise on earth," wrote Marco Polo when he sailed on Hangzhou's beautiful West Lake. You'll take the same cruise, past the lake's four islands with their carved bridges and summerhouses. Hangzhou is the favored spot for a Chinese honeymoon.

GUILIN ("Kway-linn") Your Chinese hosts will tell you that the countryside here is the most beautiful in all of China. You'll cruise on the Li River through misty hills and valleys, eerie rock formations, bamboo groves and Folded Brocade Hill.

KUNMING ("Kun ming") is the "City of Eternal Spring" and the capital of the Yunnan Province. The temperate weather permits perpetual blooming flowers. Encircled by mountains, Kunming is near the natural wonder of the Stone Forest, an extraordinary panorama of towering rock formations (some as tall as six storeys).

GUANGZHOU ("Kwang-jo"), or Canton to Westerners, is an ancient city located on a bend of the Pearl River and the site of famous trade fairs. You can do some exciting trading on your own - joining buyers and sellers from all over the world. Records show that the Romans traded here as far back as 200 B.C.

This fabulous vacation ends in style in spell-binding HONG KONG, a city of unparalleled energy. Its bargains are legend, but so are its restaurants. Its jagged skyline dwarfs New York's, yet tranquil white beaches lie within its very shadow. Her harbor will capture your heart forever -- she always does. Take the twenty minute ferry ride from Hong Kong to Kowloon, where you can shop for bargains from around the globe.

Your all-inclusive China vacation, with a professional bi-cultural Tour Director and a small group of your fellow members and friends from The New Jersey Federation of Women's Clubs, the cost is as low as $3699 from Newark. We're leaving on Friday, April 17th, 1987. This will be the travel highlight of your life!

RESERVE NOW!! -- SPACE IS LIMITED -- YOU'LL BE TRAVELING WITH ONLY 34 COMPANIONS -- JUST $300 GUARANTEES YOUR PLACE

Make your reservation today -- THE DESTINATION OF THE 80's -- CHINA -- promises to be the vacation of a lifetime -- Call Olga Mackaronis at 201-249-5485 or mail the reservation form in the enclosed reply envelope today. You can charge your deposit -- or your entire trip -- to your American Express, MasterCard or Visa credit card. Our reservation center is open 9:30 am to 4:30 pm Monday through Friday.

Sincerely,

Betty P. Loizeaux

Mrs. Jerry B. Loizeaux
State President

P.S. Reserve NOW!! Space is limited. Reservations will be accepted on a first-come, first-served basis. You will be traveling with only 34 companions and just $300 reserves your place on this once in a lifetime vacation! And one more thing - reserve before November 15, 1986 and receive an additional $50 reduction per person or $100 per couple off the total cost of your vacation!

HERE'S WHAT'S COVERED IN YOUR ALL INCLUSIVE TOUR

You don't have to worry about a thing!

- Round trip jet transportation via Japan Airlines or similar scheduled carrier with inflight movie, meal and beverage service
- Deluxe/First Class hotel accommodations: 1 night at the Narita Nikko in TOKYO; 3 nights at the Great Wall Sheraton in BEIJING; 2 nights at a CITS assigned hotel in XI'AN; 2 nights at the Hua Ting Sheraton in SHANGHAI; 1 night at a CITS assigned hotel in WUXI; 2 nights at the Hangzhou Hotel in HANGZHOU; 2 nights at the Riverside Resort in GUILIN; 2 nights at the Green Lake Hotel in KUNMING; 1 night at the White Swan Hotel in GUANGZHOU; 3 nights at the Sheraton in HONG KONG.
- Pre-registration at your hotels; all flight reservations and tickets in advance.
- Complete travel and tourist information mailed to you prior to departure.
- Experienced bi-cultural U.S. Tour Director throughout your entire vacation.
- Full Western Breakfast each morning.
- Lunch and Dinner daily within China includes: a Peking Duck Dinner in Beijing, a special Western style Dinner in Shanghai, and a Cantonese Banquet in Canton.
- A Gala Farewell Banquet Party in Hong Kong.
- All inter-city transfers.
- A Hospitality Desk hosted by overseas staff who will advise you on the local points of interest.
- Cruises on the magical West Lake while in Hangzhou; on the Grand Canal in Wuxi and on the Li River in Guilin.
- Sightseeing in each city including: the Bund (Shanghai's Waterfront) and the Jade Buddha Temple; visits to the Forbidden City, Summer Palace, the Temple of Heaven, the Great Wall and the Ming Tombs in Beijing; viewing of the incredible "Terra Cotta Army" in Xi'an plus an excursion to the unique towering rock formations in the Stone Forest near Kunming.
- Informative briefings on the highlights of each city.
- All airport, hotel, train transfers in Japan, China and Hong Kong including all tips to porters.
- All taxes and service charges for included features.
- All visa fees, departure taxes, customs and immigration fees.
- Deluxe oversized travel bag.
- A convenient passport wallet and name badge.
- The opportunity to purchase a Comprehensive Travel Insurance program.

RESERVE NOW
SPACE IS LIMITED!!

SAVINGS

Make your reservations before **NOVEMBER 15, 1986** and receive a reduction of $50.00 per person or $100.00 per couple!

The New Jersey Federation of Women's Clubs, State President Mrs. Betty. P. Poizeaux

Presents . . .

THE UNIQUE WONDERS of CHINA

8 Fascinating Chinese Cities . . .
Plus Hong Kong
Exciting 21 Days & 19 Nights!

$3699*
JFK/NEWARK/PHILADELPHIA

ALL INCLUSIVE
PRICES GUARANTEED*

Departing Friday, April 17, 1987
Returning Thursday, May 7, 1987

Additional Departure Cities and Dates Available Upon Request.

☎ **FOR RESERVATIONS OR MORE INFORMATION** ☎

Call
Olga Mackaronis at
(201) 249-5485

SPACE IS STRICTLY LIMITED! ✉

Only 34 seats per departure, so reserve today. Complete the easy Priority Booking form on reverse side and return it in the reply envelope. Take a minute to do it — NOW!

**Per person based on double occupancy*

PRIORITY BOOKING/SPACE REQUEST

RESERVATIONS FOR CHINA
NJ State Fed of Women's Clubs

1 PERSONAL INFORMATION

Name(s) ____________________
Address ____________________
City/State/Zip ____________________
Home Phone (____) ________ Bus. Phone (____) ________
I/we have read the tour participant agreement and agree to its terms
Signature ____________________

2 PAYMENT PLAN — SELECT THE ONE THAT'S BEST FOR YOU

Minimum deposit of $300 per person. Full payment is due 60 days prior to departure. For reservations made within 60 days of departure, full payment is due immediately.
Deposits can be charged to your credit card.

☐ I will pay by check.
Amount of deposit __________ # of persons __________
☐ Full payment in the amount of __________
Make check payable to **NJ STATE FED OF WOMEN'S CLUBS**
☐ I will pay by credit card.
Amount of deposit __________ # of persons __________
☐ Full payment in the amount of __________
☐ MasterCard ☐ Visa ☐ AmEx
Card # ____________________ Exp. Date __________

3 Please confirm the following reservations

	DEP. DATE	DEP. CITY	PRICE	
☐	Fri., April 17, 1987	JFK	$3899.00	All Inclusive
☐	Fri., April 17, 1987	Newark	$3899.00	All Inclusive
☐	Fri., April 17, 1987	Philadelphia	$3899.00	All Inclusive

4 SPECIAL OPTIONS

☐ I desire to have a single hotel room. Add $700.00 to the cost of my trip.
☐ If possible, I/we would like to be adjacent to __________
☐ Non-smoking Section ☐ Smoking Section
☐ I am sharing my room with __________
☐ I would like additional information on first class airfare.

Completing this form is as easy as 1, 2, 3. It takes just a few moments of your time. When you have completed all sections, detach this form where indicated and return this upper portion in the reply envelope provided.
MAKE SURE THAT THIS ADDRESS SHOWS THRU "WINDOW" IN RETURN ENVELOPE.

NJ State Fed of Women's Clubs
Attn: Olga Mackaronis
55 Clifton Avenue
New Brunswick, NJ 08901

THIS ADDRESS SHOULD SHOW
THRU "WINDOW" IN RETURN ENVELOPE

FOR RESERVATIONS OR MORE INFORMATION
Call
Olga Mackaronis at
(201) 249-5485

SPACE IS LIMITED!
FIRST COME . . . FIRST SERVED!

RETURN THIS PRIORITY RESERVATION FORM NOW.

Please print all requested information.
If more than one couple, attach separate sheet with complete information as at left. **You will receive detailed pre-trip and planning information shortly after returning this form.**

(DETACH HERE AND RETURN UPPER PORTION IN ENVELOPE PROVIDED) F 1

PARTICIPANT AGREEMENT

Reservations/Final Payments/Cancellations: Reservations are confirmed upon receipt of a deposit of $300 per person. Final payment must be made at least 60 days before your departure. Prices stated are per person and based on double occupancy. Single supplement is $700 and not guaranteed. Child reductions are available upon request. No triples or quads allowed. In the event it becomes necessary for you to cancel your reservation, there will be a handling fee of $25 per person for cancellation received more than 60 days prior to departure. The charge for cancellation from 59-30 days before departure is $300 per person, from 29-0 days before departure is $250 per person. Requests for refunds or cancellations must be made in writing or by telegram.
Optional Travel Insurance: Optional travel insurance is available. More information will be sent upon registration.
Travel Documents: A valid passport is required for everyone, regardless of age and may be obtained or renewed at any U.S. District or Superior Court or Passport Office. Your Post Office can assist and direct you on the necessary procedures. Visas are required for China and Japan. More information will be sent upon registration. Non-US citizens should check with their embassy for more information regarding their necessary travel documents.
Tax and Tips: Hotel and restaurant service charges and porterage for luggage handling as a group are included. (Note: No group porterage where prohibited by local government in restricted customs area). Tipping is unnecessary except for personal services. Gratuities given at end of tour to the Tour Director are at tour member's discretion. Taxes for group services are included.
Luggage: Within China passengers may only carry 20 kilos (44 lbs.) of luggage free. One piece of carry-on luggage is allowed which may not exceed 20x30x50cm (7.8x11.7x19.5in.) in size, or 10 lbs. in weight. Strict enforcement of the regulations will be adhered to. All excess luggage charges will be collected and paid at the airport by individual tour members. Luggage is at "owner's risk" throughout the surface portion of the tour. On trains in China, all luggage must be locked. No unlocked suitcases will be accepted. Proper insurance is recommended. Vantage is not responsible for any loss or damage to luggage or other personal belongings.
Not Included: All items of a personal nature such as laundry, telephone calls, etc. beverages or meal items not included in the menus provided on a group basis, or not indicated in the included features, excess baggage charges, gratuities for personal services, insurance of any kind.

Overnight in Gateway City: Due to limited airline connections, passengers may be overnighted in gateway or assembly city. $38 per person.

Alternate Itineraries: All land programs are contracted through the China International Tour Services (CITS) and may be altered for various reasons such as limited inter China air connections and space availability within China. Vantage Travel will attempt to advise you of any changes or deviations prior to your departure.

Responsibility: Vantage Travel Service, Inc., its affiliated and/or sponsoring organizations* and agents, act ONLY as agents for the suppliers or contractors of the services described herein, including, but not limited to airlines, suppliers of hotel and/or cruise accommodations, transportation and other tour related services. Agents shall not be responsible or liable for any delays, loss or injury to person or property due to any cause occurring during the tour.

The Agent has the discretion to alter any part of the itinerary, including, but not limited to, hotel or cruise accommodations or airlines without notice. In the event alteration in the itinerary or accommodations becomes necessary, substitutions will be of comparable quality. The Agent reserves the right to (i) cancel the tour at any time prior to departure and refund all monies in full settlement of its obligations, and (ii) decline to accept or retain any person as a member of the tour.

The cost of this vacation package is based on group promotional tariffs and foreign exchange rates in effect as of September 1986. Should there be a marked difference in the costs of these services or exchange rates due to devaluation, you will be notified of such increases approximately 30 days prior to departure. Prices are guaranteed for land and international air portions. Domestic flights are not guaranteed.

Enrollment in this trip constitutes agreement to the provisions stated.

*The above Responsibility Clause also applies to the sponsoring organization.

Swiss Bavaria

Dear Friend,

When you're very proud of something, you want to "show it off." Constantly. That's why we're personally inviting you to visit the most beautiful place in the world. Swiss Bavaria. Our home.

Although we were both brought up in the Alps region of Europe, we've never really grown accustomed to our magnificent mountains. It must be similar to the chills you feel looking at your Statue of Liberty. Or Old Faithful in Yellowstone. You never tire of the view.

We've arranged the best places for you to visit. Spend a week in Davos, a picturesque Swiss Alpine resort village, and then cosmopolitan Munich located in the heart of Bavaria. Stay a little longer with us and travel on to Innsbruck, a typically Austrian city situated in the Alps; and Zurich, Switzerland, filled with picture postcard quaintness you don't expect in a banking center. Or see the best of the Alpine region of Davos, Munich and Innsbruck, plus one of our favorite cities, Vienna, known for museums, music and food, for a complete 17 day vacation.

One of the most flattering compliments we hear from visitors is that our hospitality is second to none. You'll see it in the wonderful hotels we've chosen for you. In the Munich beerhalls that welcome you with a song. Even in our baking, when you're brought your first (of many) pieces of Viennese pastry.

And since you're visiting all the places we know like the back of our hand, we'll be able to give you the inside view of everything. We know the best places for shopping and dining. Think of us as your friendly guidebooks.

To make the most of your time here, we've even arranged for Special Journeys. You'll be able to see all the places you won't want to miss. While these optional tours are also described in your brochure, enclosed with this letter, we can't resist telling you about a few of our favorites. From Davos be sure and catch The Glacier Express, a Swiss train ride over the Alps into Italy. The scenic beauty is spectacular and it's hard not to get excited when we pass the first glacier. Plus the shopping in Italy is fabulous. This is the place to buy those Gucci handbags!

Munich is the home of our most popular tour. While Americans have Disney and its famous castle, we have the real thing — King Ludwig's Neuchwanstein Castle. Driving into the mountains, you'll suddenly look up as the castle peers down from the mountain. Was the king really mad? Hear the tale and judge for yourself.

From Innsbruck we can travel into a city everyone should see at least once. Venice. All the pictures you have in your mind ring true as you ride a gondola along the Grand Canal or wander in St. Mark's Square. You'll probably have to pinch yourself to believe it's all real!

Remember the cottage made from candy in childhood stories? In Zurich we'll take a step back to your memories of Hansel and Gretel and visit the Black Forest. This is the place to buy world famous cuckoo clocks.

While Vienna is a multitude of sights on its own, who could resist taking a peek behind the Iron Curtain? Join us in Budapest, Hungary. This is your chance to mingle with people from Russia, Poland and East Germany.

We'd love to brag forever, but we'd rather tell you the rest in person. Reserve right now and come for a visit. Hold your place with a $150 per person deposit and send it along with the enclosed Reservation Form. But don't take too long. We can't wait to have you here!

Auf Wiedersehen,

Anna Maeder　Honey Streit-Reyes

Anna Maeder
Swiss Tour Director

Honey Streit-Reyes
Bavarian Tour Director

P.S. Guarantee your price on our Swiss Bavaria vacation right away. Be sure to send in your $150 deposit within the next 21 days — lock in this special price today!

A Message From
Betty P. Loizeaux
State President

Dear Member:

When we first sat down to arrange this trip especially for you, we thought about the 5 elements that would make this the best vacation ever. This Swiss Bavaria vacation not only meets our requirements — it surpasses them!

First, we looked for quality. We found it in the top-rated airlines. The First-Class and Deluxe hotels. And in the friendly, helpful TNT guides all along the way.

Then we wanted relaxation. What good is coming home from a vacation more exhausted than when you left? On the Swiss Bavaria tour, all the details are taken care of for you — everything is paced so that you can enjoy what you want, when you want. You have plenty of pampering and service to look forward to.

We needed a special itinerary. We felt the itinerary should be planned to really let you experience the places you see. By the end of the complete trip, you'll have visited 4 incredible cities and 3 amazing countries! You'll get the very best taste of all that Swiss Bavaria has to offer in 8, 14 or 17 days.

And what about fun? This is a delightful vacation! The welcoming parties, slide show briefings and sightseeing tours bring all of us together for good times.

Finally, we demanded value and savings. It would be hard to find this kind of trip at a comparable price anywhere. Just consider the time you'd have to spend putting the same trip together on your own. It's all done for you.

And, if you book within the next 21 days, you'll be assured of our group price. Send in your $150 deposit right away — guarantee this special price today!

Sincerely,

Betty P. Loizeaux

Betty P. Loizeaux
State President

625 FIX
0030-SWB7

How to Book:
You can make your reservations 2 ways. *By phone*, call the number listed inside, or by *mail*, fill out this Reservation Form and mail it to the address at the right.

• NEW JERSEY STATE [illegible]
OF WOMEN'S [illegible]
Attn: Mrs. [illegible]
55 Clifton Avenue
New Brunswick, NJ [illegible]

TOUR PARTICIPANT CONTRACT TRANS NATIONAL TRAVEL, The Trans National Building, 2 Charlesgate West, Boston, Massachusetts 02215-3552, acts only as an agent for the airlines, other transportation companies (including but not limited to railroads, motorcoach operators, cruise lines, rental car companies, hotels, restaurants, and other travel suppliers) in arranging to provide the services and accommodations included in your TNT vacation. Accordingly, TNT ASSUMES NO LIABILITY FOR, AND THE PASSENGER AGREES THAT TNT SHALL NOT BE RESPONSIBLE OR LIABLE FOR, AND WAIVES ANY CLAIMS AGAINST TNT ARISING OUT OF (a) any loss, expense, damage, accident, delay, inconvenience, irregularity, injury, or death which results from or is occasioned by, directly or indirectly, any defect or the acts or failures to act, whether negligent or otherwise, of any such airline, other transportation company, rental car company, hotel, restaurant, or other travel supplier engaged in conveying the passenger or otherwise carrying out the arrangement included in your TNT vacation or related connecting flights, including but not limited to delays, schedule changes, or flight cancellations by the airline, overbooking by the airline or hotels, or strikes affecting the airline or hotels, or (b) any other cause or factor of whatsoever nature beyond TNT's control. TNT reserves the right to decline, to accept or retain any person as a member of the air tour or to change or withdraw such tour at any time as circumstances warrant. Any deviation from such tour which the passenger indicates is solely the responsibility of the passenger. TNT reserves the right to change any part of the itinerary. This also applies to the sponsoring organizations.

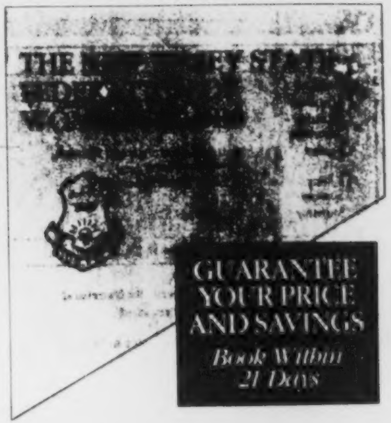
CANCELLATIONS AND REFUNDS: If you cancel your reservation (and you did not purchase the insurance), your right to receive a refund is limited as set forth in the following schedule. If your notice before departure or change of date is received 60 or more days before departure, you will be charged a $25 per person fee; 59-30 days before departure, you will be charged a $150 per person fee; 29-0 days before departure, you will be charged a $400 per person fee. All requests must be sent to TNT in writing and TNT reserves the right to refuse substitutions within 30 days of departure.

MISCELLANEOUS: This contract is governed by, and construed in accordance with, the laws of the Commonwealth of Massachusetts.
Trans National Travel (TNT), 2 Charlesgate West, Boston, Massachusetts 02215-3552

TNT PRICE TERMS: In the event of misquoted prices, the passenger will be offered the tour at the correct price or may cancel with a full refund of the unused portion of the tour.

BAGGAGE: Liability for loss, damage, or delay of baggage is solely that of the carrying airline, whether charter or scheduled.

DOCUMENTATION: Possession of proper documentation is solely the responsibility of the passenger.



GUARANTEE YOUR PRICE AND SAVINGS
Book Within 21 Days

Swiss Bavaria

8 DAYS, 7 NIGHTS

Davos, Switzerland • Munich, Germany

$899 NEW YORK

$999 PHILADELPHIA

14 DAYS, 13 NIGHTS

EXTEND YOUR VACATION TO INCLUDE
INNSBRUCK, AUSTRIA & ZURICH, SWITZERLAND
- OR -

17 DAYS, 16 NIGHTS

EXTEND YOUR VACATION TO INCLUDE
INNSBRUCK & VIENNA, AUSTRIA

Departing
SUNDAY, JULY 12, 1987

ITINERARY

Switzerland & Germany 7 Night Program:

Sunday	Depart U.S.A.
Monday	Arrive in Davos, **Switzerland**
Monday - Thursday	Davos, **Switzerland**
Friday	Motorcoach transfer to Munich, **West Germany**
Friday - Sunday	Munich, **West Germany**
Monday	Return to U.S.A.

Switzerland, Germany & Austria 13 Night Program:

Sunday	Depart U.S.A.
Monday	Arrive in Davos, **Switzerland**
Monday - Thursday	Davos, **Switzerland**
Friday	Motorcoach transfer to Munich, **West Germany**
Friday - Sunday	Munich, **West Germany**
Monday	Motorcoach transfer from Munich to Innsbruck, **Austria**
Monday - Thursday	Innsbruck, **Austria**
Friday	Motorcoach transfer from Innsbruck to Zurich, **Switzerland**
Friday - Saturday	Zurich, **Switzerland**
Sunday	Return to U.S.A.

Switzerland, Germany & Austria 16 Night Program:

Sunday	Depart U.S.A.
Monday	Arrive in Davos, **Switzerland**
Monday - Thursday	Davos, **Switzerland**
Friday	Motorcoach transfer to Munich, **West Germany**
Friday - Sunday	Munich, **West Germany**
Monday	Motorcoach transfer from Munich to Innsbruck, **Austria**
Monday - Thursday	Innsbruck, **Austria**
Friday	Motorcoach transfer from Innsbruck to Vienna, **Austria**
Friday - Wednesday	Vienna, **Austria**
Wednesday	Return to U.S.A.

Please see the full-color brochure for a complete list of your many Included Features.

DEPARTURES *(Check those that apply)*

Prices are per person based on double occupancy.

Departure Date	City	7-Night Price	13-Night Price	16-Night Price
07/12/87	New York	☐ $899	☐ $1298	☐ $1647
07/12/87	Philadelphia	☐ $999	☐ $1398	☐ $1747

Departures from certain cities may require an overnight before or after the trip: the overnight charge is $49 per person, per night double occupancy and $79 per single, per night.

OTHER DEPARTURE DATES AND CITIES AVAILABLE. CALL 1 201-249-5485 FOR DETAILS.

Please reserve ______ seats for the departure checked above in ☐ smoking ☐ non-smoking.

ACCOMMODATIONS *(Check those that apply)*

SINGLE HOTEL ROOMS:

☐ 7 Nights — Add $115 to final payment
☐ 13 Nights — Add $200 to final payment
☐ 16 Nights — Add $440 to final payment

TRIPLE/QUAD HOTEL ROOMS PER PERSON:

☐ 7 Nights — Subtract $30 from final payment
☐ 13 Nights — Subtract $45 from final payment
☐ 16 Nights — Subtract $125 from final payment

MEAL PLAN PER PERSON:

☐ 7 Nights: 6 Breakfasts & 3 Dinners — Add $100
☐ 13 Nights: 12 Breakfasts & 6 Dinners — Add $190
16 Nights: N/A in Vienna (choose one of the above)

ADJACENT ROOMS/MATCHING ROOMMATES:

☐ If possible, I would like a room adjacent to: ______________________

☐ Please arrange a roommate for me (*If by 30 days before departure you do not have a roommate, the single occupancy supplement price listed above will be cut in half.)

RESERVING BY MAIL *(Please print)*

Name

Address

City *State* *Zip*

Phone
Home (   ) *Work (   )*

Names of Roommate(s)

If traveling with more than one person, attach a separate list of their names, addresses and phone numbers to this form.

HOW TO PAY *(By check, money order or credit card)*

Deposit ☐ *$150 per person*
or ☐ *full payment (required within 60 days prior to departure)*

Enclosed is a check payable to N.J. Fed. of Women's Clubs for: $ for (No. of) persons

CHARGE MY: ☐ *MasterCard* ☐ *VISA* ☐ *American Express*

Acct. No. | | | | | | | | | | | | | | | | |

Name of Cardholder

Exp. Date | | | - | | |

I/We have read the Tour Participant Contract and agree to its terms.

Signature(s)

☐ *I have confirmed my reservation by telephone with a credit card on ______________________ (give date).*

For reservations or information call Olga Mackaronis

201-249-5485

G.M.A.E. TRAVEL

Tours sponsored by the GREATER MINNEAPOLIS ASSOCIATION OF EVANGELICALS
3361 Republic Ave., Minneapolis, MN 55426
(612) 920-8147

April 1987

TO: Our G.M.A.E. Travel Friends

FROM: Palmer Yngsdal, Director of Travel

SUBJECT: Spring and Summer Travel Opportunities

Already this year has been an exciting adventure in travel for many of our travel friends. Groups have been to Hawaii in January, Florida in February and Israel in March. It's been busy, but FUN!

What's ahead?

May 7-9 - PELLA TULIP FESTIVAL & AMANA COLONIES
Last call! If you are going, reservations MUST be in NOW!

June 17-19 - HOUSE ON THE ROCK AND WISCONSIN DELLS
Visit the House on the Rock, its fabulous museum, Little Norway, the Tommy Bartlett Ski, Sky and Stage Show, a boat cruise in the Dells, etc. It's a great tour. A number of reservations are in. Many others have indicated they're going with us. Please hurry on getting your reservation in. It really helps us with all the details and advanced commitments.

N E W T O U R A D D E D

BEAUTIFUL COLORADO and the BILLY GRAHAM COLORADO CRUSADE at Mile High Stadium in Denver, July 18-26. We will attend the Crusade five evenings. Each day during the week we will visit special places in Colorado. Included are: Central City; Rocky Mountain Nat'l. Park; the Garden of the Gods; the Air Force Academy; the High Rockies and Vail; and much more. This will be a popular trip. Brochures are ready. Get your reservations in soon. Don't Miss It! You will never forget this great inspirational and gorgeous sightseeing adventure.

Aug. 21-Sept. 3 - ALASKA & THE YUKON TERRITORY
This tour is over two-thirds full already. It will be very popular. Visit Ketchikan, Juneau, Skagway, Whitehorse, Fairbanks, McKinley Park, Anchorage and other sites in our northernmost State. Call for the brochure. Early reservations are a must on this one. It looks like it will be sold out fairly soon. Many have requested the brochure. We will honor reservations as we receive them until full.

OTHER TOURS IN THE FALL

Sept. 21-25 - AGAWA CANYON & MACKINAC ISLAND
Travel across Wisconsin in beautiful autumn; journey by train over 100 miles into the Canadian wilderness; see Mackinac Island "the Bermuda of the North", its fabulous Grand Hotel and horse-drawn carriages.

October 5-13 - THE OZARKS
Eureka Springs, Hannibal, Kansas City, St. Louis, the Truman Library, Thorncrown Chapel, the Passion Play, Gateway Arch, Mark Twain Museum, Independence, etc. are places we will visit.

Oct. 25-Nov. 2 - TENNESSEE FOLIAGE
Nashville with Opryland, Chattanooga, Lookout Mountain, Gatlinburg, the Great Smoky Mountains Nat'l. Park, Knoxville, Indianapolis, and much more. A great fall travel experience.

NOTE: TWO ONE-DAY TOURS THIS SUMMER

Tuesday, June 30 - CEDAR LAKE FARM, New Prague, MN

Thursday, Aug. 6 - HISTORIC MANTORVILLE & ROCHESTER, MN

Call for the special brochure for the 1-day tours, 920-8147.

I look forward to seeing you on tour this summer. Hurry with your favorite destination reservation.

TOURS
GREATER MINNEAPOLIS ASSOCIATION OF EVANGELICALS
3361 Republic Ave., Minneapolis, MN. 55426

4/87

Non-Profit Org.
U. S. Postage
PAID
Mpls., Mn
Permit No. 1125

EL MAIDA TEMPLE presents...

ALASKA ABOARD THE LUXURIOUS REGENT SEA

August 30-September 6, 1987
From $1499 per person, double occupancy
including air from El Paso.

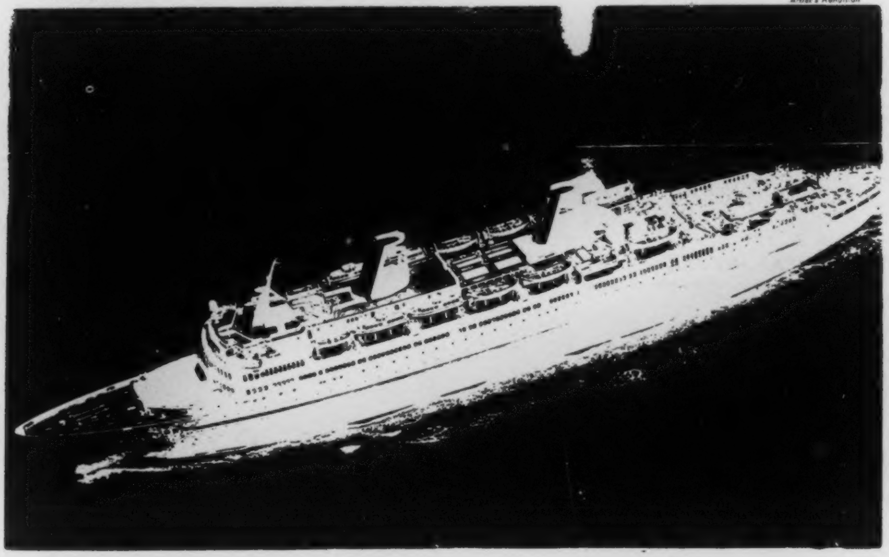
Bert and I are pleased to extend an invitation to you, your family and friends of El Maida Temple to join us on this exciting cruise aboard the elegant and spacious REGENT SEA. We will be sailing on one of the most interesting itineraries available, cruising from Anchorage to Vancouver all in seven days! Join your fellow Nobles and Ladies of El Maida Temple as we experience this unique travel opportunity. I sincerely hope that you will make plans now to join us on what I know will be a long remembered vacation.

Bon Voyage

Ed Hughes
Potentate

REGENCY
CRUISES

Artist's Rendition



HERE'S WHAT IS INCLUDED:

- [illegible] E[illegible] Anchorage to meet [illegible]
- [illegible] Sea from Anchorage to [illegible] Ketchikan and Vancouver [illegible]
- A[illegible] and have private facilities, a [illegible] music
- Superb [illegible] cuisine with the accent on French, with four major dining experiences planned each day. Breakfast, full course lunch and dinner as well as midmorning bouillon, afternoon tea and late night buffet
- Complimentary Captain's Welcome Aboard Party, several theme evenings and Farewell Dinner
- Exclusive EL MAIDA TEMPLE Get-Acquainted Party hosted by the Potentate and his Lady to meet new friends
- Special TCT Cruise Representative on board to assist you
- See Cabaret and folkloric shows. Attend first run movies
- Friendly crew to serve you

A Vacation of a Lifetime: A one-way Alaska Cruise offers you the sights that you just can't see on a 7-day round-trip cruise from Vancouver

This summer, make this the cruise you take–you're in for the time of your life!

OPTIONAL TOUR INFORMATION

Add to your cruise holiday by choosing from the exciting optional pre and post tours below.

ANCHORAGE $120 per person*
You'll kick off your cruise with 2 days and [illegible] in beautiful Anchorage. There will be a half-day sightseeing tour and plenty of time to explore Alaska's most bustling city on your own. (Limited availability.)

VANCOUVER $260 per person*
The finale to your cruise holiday will be 3 days and 2 nights in the beautiful, international city of Vancouver. Be sure to take advantage of the fabulous shopping and elegant restaurants of Robson Street, explore Old Gastown and maybe take the ferry to Victoria, known as the "City of Gardens". (Limited availability.)

*Double occupancy which includes deluxe hotel and transfers.

PORTS-OF-CALL:

Whittier (Anchorage)–Your holiday begins in Alaska's [illegible] city, Anchorage. From there you will take a scenic [illegible] to Whittier, Anchorage's port city, where you will board the M/V Regent Sea and begin your fabulous cruise

College Fjord/Columbia Glacier–College Fjord is [illegible] view the sixteen gleaming glaciers with the prestigious names such as Dartmouth, Harvard and Yale to name a few. From College Fjord, a few cruising hours away is Columbia Glacier, the most active tidewater glacier in North America if not the world. While cruising, watch for wildlife or perhaps a seal resting out [illegible] an ice flow.

Yakutat Bay/Hubbard Glacier–Cruising to Yakutat Bay you will see famous Hubbard Glacier. An impressive six miles wide and 500 feet high, the sheer size of this body of ice in the water is an incredible site to behold

Skagway–The frontier town famed as the jumping off place for the rush to the gold in the Klondike. The facade of every building on Main Street has been handsomely restored, we may be welcomed on arrival by can can girls and horsedrawn hacks that will whisk us into town. You'll also have a chance to take a gold-rush excursion to the Klondike, following the actual trail the miners once took.

Juneau–Everyone's favorite port of call in Alaska! W[illegible] stairs stilting up steep cliffs replace streets in this wonderful [illegible] mining town, or ride up in a tram! And then drive right up to Mendenhall Glacier, a twelve-mile river of ice terminating [illegible] 200 feet deep. Or take a breathtaking flight over the Juneau [illegible]. Consider going to an Alaskan salmon bake–the [illegible] est of fish cooked perfectly over a smoking alderwood fire. [illegible] to stop for a refreshment at the world-famous Red Dog Saloon.

Ketchikan–The [illegible] capital of the World [illegible] Totem Bight Park where the [illegible] collection of [illegible] totem poles are found [illegible] totem poles are [illegible] from the past!

Vancouver–Upo[illegible] you will be transferred to the airport for departure to your [illegible].

ABOUT YOUR SHIP:

The Regent Sea is b[illegible] size (22,000 tons)–with approximately 710 passengers sa[illegible] each cruise. Your stateroom [illegible] one of the largest on an[illegible] afloat. 95% are outside cabins with a panoramic view of the sea, [illegible] have private facilities and 50% have both bath and shower.

Just for starters, there are nine lounges and three bars on board, with entertainment happening almost around the clock–including music and afternoon tea, lectures and games and movies throughout the ship, a full gaming room and a late night discotheque with the latest sounds from private clubs of Paris and Rome to the jungle clubs of South America.

All-in-all, you'll be in for a wonderful time!

Cancellation Charges Waiver – 7 Day Alaska Cruise. TCT [illegible] offer the passenger an optional C[illegible] Charges Waiver (CCW) [illegible] of $30. The CCW will protect the passenger [illegible] cancellation charges listed under Travel Tips) if the [illegible] decides to cancel the cruise reservation, provided that written notice is received by Trans Continental Travel, 2655 Campus Drive, San Mateo, California 94403, [illegible] 24 hours prior to the [illegible] scheduled embarkation on the vessel. Cancellations within 24 hours of the scheduled embarkation will be subject to the cancellation charges described under Travel Tips.) The $30.00 fee for the CCW is not refundable, even if the cancellation is made prior to final payment of the cruise fare. If the passenger purchases the CCW, payment must be made at time of deposit. Some airlines impose penalties for changes and/or cancellations of air itineraries. Those charges are not covered by Trans Continental Travel's Cancellation Charges Waiver outlined above, these charges will be the responsibility of the passenger. If the CCW has been declined, the cancellation of a cruise is subject to the c[illegible]llation charges listed under Travel Tips.

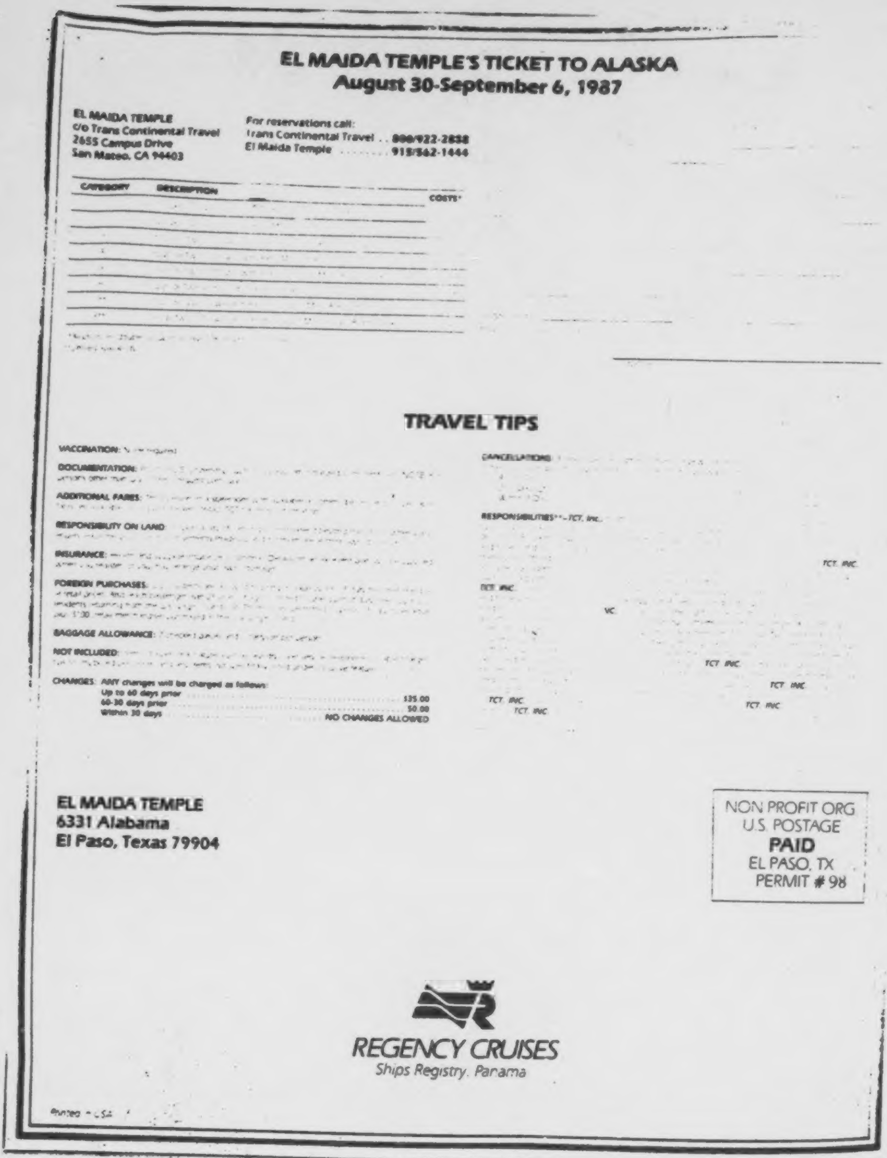
Join Us For a

Special Cruise Presentation

Wednesday, February 25, 1987

7:30 p.m. at the Temple

ARABIA ROOM



EL MAIDA TEMPLE'S TICKET TO ALASKA
August 30-September 6, 1987

EL MAIDA TEMPLE
c/o Trans Continental Travel
2655 Campus Drive
San Mateo, CA 94403

For reservations call:
Trans Continental Travel . . 800/922-2838
El Maida Temple 915/562-1444

CATEGORY	DESCRIPTION	COSTS*

TRAVEL TIPS

VACCINATION: [illegible]

DOCUMENTATION: [illegible]

ADDITIONAL FARES: [illegible]

RESPONSIBILITY ON LAND: [illegible]

INSURANCE: [illegible]

FOREIGN PURCHASES: [illegible]

BAGGAGE ALLOWANCE: [illegible]

NOT INCLUDED: [illegible]

CHANGES: ANY changes will be charged as follows:
Up to 60 days prior $35.00
60-30 days prior $50.00
Within 30 days . . . . . . NO CHANGES ALLOWED

CANCELLATIONS: [illegible]

RESPONSIBILITIES—TCT, Inc. [illegible]

EL MAIDA TEMPLE
6331 Alabama
El Paso, Texas 79904

NON PROFIT ORG
U.S. POSTAGE
PAID
EL PASO, TX
PERMIT # 98

REGENCY CRUISES
Ships Registry, Panama

Printed in USA

El Maida Temple
A.A.O.N.M.S.

HAROLD SHOPPACH
Potentate

RAY EDELMAN
Recorder

Oasis of El Paso • Desert of Texas • 6331 Alabama 79904 • (915) 562-1444

Dear Noble:

There are few experiences as enjoyable and memorable as traveling with your family and fellow Nobles.

That's why I'm delighted to tell you that we have arranged a special Caribbean Cruise aboard Carnival Cruise Lines' ms Holiday for Nobles of El Maida Shrine Temple, A.A.O.N.M.S -- and I want to personally invite you to join them!

Every detail of this great travel opportunity has been planned with the help of Trans National Travel, the experienced group travel professionals. See the beautiful brochure enclosed for all the details on this cruise.

Let me assure you everything has been taken care of for you -- from your round trip scheduled jet transportation (except dockside departures) to comfortable cabin accommodations, use of all the ship's facilities and eight meals every day while on board. We've also arranged for you to enjoy all of the ship's special parties and events, a variety of optional shore excursions, and much more -- including the freedom for you to go off on your own if you prefer.

Please join your fellow Nobles for a week aboard the Holiday. And, you can be sure that your beautiful Caribbean ports of call of St. Maarten, St. Thomas and Nassau -- will add to the enjoyment of this special cruise.

Reserve your place right now so you won't miss out. See the enclosed Reservation Form for departure information. Then return the form with your deposit of $150 per person or call toll-free 1-800-262-0123. Charge your vacation to one of your major credit cards if you like.

ED HUGHES
Chief Rabban

JOHN DORAN
Assistant Rabban

MERVE MORGAN
High Priest & Prophet

JOHN COMMANDER
Oriental Guide

FREEMAN HARRIS
Treasurer

Now's the best time to travel -- the values are better than ever. take advantage of this wonderful travel opportunity and reserve your place on our Caribbean Cruise today. This is the one!

Yours in the Faith,

Harold Shoppach

Harold Shoppach
Potentate

P.S. As an added feature, there will be a total of nine Texas Shrines sailing on this exciting one week cruise and they are: Al Amin, Alzafar, Arabia, Ben Hur, El Maida, Khiva, Maskat, Sharon and Suez Shrine Temples, A.A.O.N.M.S. So don't be left out -- make your reservation today!

5186F1X

RESERVATION FORM

Potentate Harold Shoppach and His Lady Ginger of El Maida Temple, A.A.O.N.M.S. Invite you to join them and the Nobles of Al Amin, Alzafar, Arabia, Ben Hur, El Maida, Khiva, Maskat, Sharon and Suez Shrine Temples on the HOLIDAY CRUISE

WHICH INCLUDES:

- Round trip scheduled jet transportation with in-flight meals and beverage service.†
- Transfers from airport to ship and baggage handling on the pier and ship (except through Customs areas).†
- Cabin accommodations for 7 nights (upper & lower berths on Empress, Main, Riviera or Upper deck) aboard Carnival Cruise Lines' ms Holiday.
- Cabin upgrade options that give you the opportunity to purchase superior accommodations.
- Eight meals every day including a Midnight Buffet.
- Welcome Aboard Party.
- Captain's Cocktail Party.
- Gala Captain's Farewell Dinner.
- Access to all shipboard facilities including sauna, gymnasium, swimming pool, lounges, card room and game room.
- Nightly entertainment.
- Duty-free shopping on board and in each port of call.
- 24-hour a day stateroom service.
- Port taxes.
- Briefings on the highlights of each port of call.
- A variety of optional shore excursions available for purchase at your ports of call.
- Complete travel information mailed to you before departure.

†except on dockside Miami departures.

ALL-INCLUSIVE PRICING!

CARIBBEAN CRUISE

7 days, 7 nights
aboard Carnival Cruise Lines'

—ms HOLIDAY—

PORTS OF CALL:
St. Maarten, Netherland Antilles;
St. Thomas, U.S. Virgin Islands; Nassau, Bahamas

$799
DOCKSIDE MIAMI

$999
DALLAS/EL PASO

DEPARTING SATURDAY, NOVEMBER 1, 1986.
All-inclusive price includes tax and services.
Per Person. Based on double occupancy.

For Reservations and Information
Call Toll-Free

1-800-262-0123

Weekdays from 8:30 a.m. to 9:00 p.m.,
Weekends from 9:00 a.m. to 5:00 p.m. (EST).
Make sure to have this RESERVATION FORM handy when you call.

Call Toll-Free for Reservations

1-800-262-0123

or, if you prefer, for more information call:
Ray Edelman at 915-562-1444

To Reserve by Mail (Please Print)

Mr./Mrs./Miss ______________________

Address ______________________

City ______________ State ______ Zip ______

Phone (   ) ______________ (   ) ______________
Home / Work

Name of cabinmate(s) ______________________

If traveling with more than one person, attach a separate list of their names, addresses and phone numbers to this Reservation Form.

If possible, I would like
a cabin adjacent to ______________________

I/We have read the Tour Participant Contract below and agree to its terms

Signature(s) ______________________

How To Pay: (by check, money order or credit card)

☐ $150 per person deposit or ☐ full payment (required within 60 days prior to departure)

Enclosed is $__________ for (No. of)______ person(s) made payable to

OR ☐ Charge my ☐ MasterCard ☐ Visa ☐ American Express
☐ American Express® Card Sign and Travel® Account

Acct. No. ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐

Exp. Date ☐☐ - ☐☐

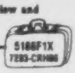
Name of Cardholder ______________________

Signature ______________________

☐ I have confirmed my reservation by telephone with a credit card on ______________ (give date)

EL MAIDA SHRINE TEMPLE, A.A.O.N.M.S
Attn: Ray Edelman, Recorder
6331 Alabama
El Paso, TX 79904

Please detach Reservation Form along dotted line below and mail to the address above or call the number above for reservations.



Accommodations and Departures (Check those that apply)

Depart/Return	City	Base Price Per Person
☐ 11/01/86 - 11/08/86	Miami	$ 799
☐ 11/01/86 - 11/08/86	Dallas	$ 999
☐ 11/01/86 - 11/08/86	El Paso	$ 999

Other departure cities, single cabin accommodation price, prices for the third or fourth person in a cabin or prices for children under 16 accompanying two adults call toll-free 1-800-262-0123.

I want to upgrade my cabin accommodations to (please indicate first and second choice categories):
Prices are per person. Based on double occupancy.

____ **A** - upper & lower, Empress, Main, Riviera & Upper decks	**Base Price per person***
____ **B** - inside twin, Riviera deck	**$ 99 Additional per person**
____ **C** - inside twin, Main deck	**$159 Additional per person**
____ **D** - inside twin, Upper or Empress deck	**$199 Additional per person**
____ **E** - outside twin, Main or Riviera deck	**$259 Additional per person**
____ **F** - outside twin, Upper or Empress deck	**$299 Additional per person**

***Base Price cabins are very limited and are on a first-come, first-served basis.**

Please reserve ____ seats for the departure checked above in the ☐ smoking ☐ non-smoking section of the airplane.

At meals, I would prefer the ☐ early seating ☐ late seating **and** ☐ smoking ☐ non-smoking section of the dining room.

✂

Fill in and retain for your records: Destination______________________ Depart/Return______________________

TOUR PARTICIPANT CONTRACT RESPONSIBILITY: TRANS NATIONAL TRAVEL, The Trans National Building, 2 Charlesgate West, Boston, Massachusetts 02215-3502, acts only as an agent for the airlines, other transportation companies (including but not limited to railroads, motorcoach operators, cruise lines, rental car companies, hotels, restaurants, and other travel suppliers) in arranging to provide the services and accommodations included in your TNT vacation. Accordingly, TNT ASSUMES NO LIABILITY FOR, AND THE PASSENGER AGREES THAT TNT SHALL NOT BE RESPONSIBLE OR LIABLE FOR, AND WAIVES ANY CLAIMS AGAINST TNT ARISING OUT OF: (a) any loss, expense, damage, accident, delay, inconvenience, irregularity, injury, or death which results from, or is occasioned by, directly or indirectly, any defect or the acts or failures to act, whether negligent or otherwise, of any such airline, other transportation company, rental car company, hotel, restaurant, or other travel supplier engaged in conveying the passenger or otherwise carrying out the arrangement included in your TNT vacation or related connecting flights, including but not limited to delays, schedule changes, or flight cancellations by the airline, overbooking by the airline or hotels, or strikes affecting the airline or hotels, or (b) any other cause or factor, of whatsoever nature, beyond TNT's control. TNT reserves the right to decline, to accept or retain any person as a member of the air tour or to change or withdraw such tour at any time as circumstances warrant. Any deviation from such tour which the passenger indicates is solely the responsibility of the passenger. TNT reserves the right to change any part of the itinerary.

AIR TRANSPORTATION: TNT and the airline reserve the right to substitute another duly-licensed air carrier and/or to change the aircraft type, capacity, and routing, and do not guarantee single-plane service. No refund will be given for such substitutions or changes. Additionally, TNT reserves the right to change the form of air service from scheduled flight to charter flight.

OVERNIGHT IN GATEWAY CITY: Due to limited or connecting space passengers may be overnighted in gateway/destination city. The overnight charge is [illegible] per person, per night based on double occupancy; and [illegible] per single traveler, per night.

BAGGAGE: Liability for loss, damage, or delay of baggage is solely that of the carrying airline, whether charter or scheduled. All claims are subject to proof of amount of loss, and, to preserve the passenger's rights, should be presented directly to the carrying airline in writing immediately upon discovery of the claim.

Trans National Travel (TNT), 2 Charlesgate West, Boston, Massachusetts 02215-3502

CANCELLATIONS, CHANGES OF DATES and REFUNDS: IF YOU CANCEL OR CHANGE THE DATES OF YOUR RESERVATION, YOUR RIGHT TO RECEIVE A REFUND IS LIMITED as set forth in the following schedule. Cancellations may be made by phone or mail, however, requests for refunds must be sent to TNT in writing at its address shown below, and shall be effective upon receipt by TNT. With respect to the landsea portion of your TNT vacation, the following cancellation schedule shall apply:

If your notice before departure or change of date is received	you will be charged
60 or more days before departure	$25.00 per person fee
59-30 days before departure	$150.00 per person fee
29-0 days before departure	$300.00 per person fee

Failure to make timely payment to TNT as required by this contract shall constitute automatic cancellation by you, in which case the above refund schedule shall apply. Timeliness of payment shall be determined by the date of receipt of the payment by TNT.

Cancellation of the air portion of your TNT vacation, including the failure to make timely payments to TNT which shall automatically constitute such a cancellation, and any refunds relating thereto, shall be governed by the airline's tariff or conditions of carriage, as applicable. Trip Cancellation, Health, Baggage and Accident Insurance is available and highly recommended.

No refund will be made for included accommodations or services which you do not use.

TNT PRICE TERMS: Prices in TNT's brochure are based on airline, hotel, ground service, and other prices, including monetary exchange rates, in effect on June, 1985. TNT reserves the right to increase the price of the tour for any reason. In the event of misquoted prices, the passenger will be offered the tour at the correct price or may cancel with a full refund of the unused portion of the tour.

MISCELLANEOUS: This contract is governed by, and construed in accordance with, the laws of the Commonwealth of Massachusetts. ACCEPTANCE BY THE PASSENGER OF A REFUND OFFERED UNDER THIS CONTRACT SHALL CONSTITUTE A WAIVER OF THE PASSENGER'S OTHER RIGHTS AND REMEDIES, IF ANY.

The above Responsibility clause also applies to the sponsoring organization.

The Most Worshipful Grand Lodge of Texas
Ancient Free & Accepted Masons

HARVEY C. BYRD
GRAND SECRETARY
P O BOX 446
WACO TEXAS 76703

TELEPHONE
AREA CODE 817
753-7395
WACO, TEXAS

For Most People, Crossing the Atlantic
Is the Travel Adventure of a Lifetime. But for YOU
Something Far More Spectacular Awaits.

The Other Side of the World

Join Your Fellow Members, Their Families and Friends
on This Dream-Fulfilling, All-Inclusive
18 Day Adventure to

THE SOUTH PACIFIC

Dear Member:

It's with a great deal of pleasure that I announce the details of a vacation that promises to be one of the high points in the history of our organization.

Picture, if you will, spectacular fjords and palm fringed beaches. Tranquil, timeless countryside and sophisticated cities. Exotic wildlife and gracious people who welcome visitors to their homes.

It all can be yours, soon, when you travel with a friendly group of people you know from the Grand Lodge of Texas AF & AM . . . out to the lands rich in contrast and beauty - hospitable and downright fascinating Australia and New Zealand ... and fabulous, never-to-be forgotten Tahiti!

No question, these are the "someday" . . . the "dream" destinations of virtually every traveler, no matter how experienced. And now you can reach them in superb comfort - escorted every step of the way and traveling in the best of company with your own good friends. Best of all, you can save hundreds of dollars and still enjoy far more than you could ever arrange on your own.

BUT MORE ABOUT HOW MUCH YOU CAN SAVE - AND WHAT'S INCLUDED - LATER

First, think of all the natural beauty and exotic culture you'll find in Australia and New Zealand ... so different, yet with many shared traditions similar to our own. English-speaking, of course, so you'll feel right at home (especially in New Zealand, where you can experience the famous hospitality at a home-hosted family dinner).

And Tahiti? Its language is beauty. French and Polynesian influences have made these islands unique in the world - South Pacific pearls glazed with a touch of Western charm and surrounded by azure seas ... the perfect complement to the grandeur and expanse of Australia and New Zealand.

LOOK AT THE FEATURES OF THIS "CAREFREE" VACATION!

Included are round-trip jet transportation with in-flight movie, meal and beverage service, deluxe hotel accommodations, welcome parties in Melbourne and Sydney, Australia; Queenstown and Te Anau, New Zealand and Papeete, Tahiti.

All transfers, all taxes and service charges are taken care of, as well as breakfast each morning, special dinners and many sightseeing highlights.

You'll enjoy making new friends and traveling with people of your own professional and social background and because your destination is so special, it's likely to lead to special bonds of friendship.

To insure your comfort and peace of mind, every travel detail has been taken care of for you by the experts at Vantage Travel.

That means there's very little for you to do - except make reservations and take off! You'll get all kinds of helpful planning and pre-trip advice on what to take along, what documents you'll need, what the food and weather's like, what shopping bargains you can anticipate...

...indeed, the solid information and guidance you get - both before you go and all along the way - makes everything easy ... virtually guaranteeing your trip will be carefree and relaxed so you can enjoy yourself to the fullest.

Speaking of guarantees, that's one of the many reasons we chose Vantage Travel Service over a number of similar organizations to plan and arrange our trip: Vantage guarantees pricing and makes sure you get full value - including scheduled air service, delightful first-rate accommodations, dedicated services of an experienced Tour Director, local hosts and more.

You see, Vantage Travel thoroughly researches and "field tests" airlines, hotels, ships, restaurants and sightseeing on a continuing basis so they know firsthand how to enjoy the South Pacific most (as well as what to avoid). You benefit from their years of experience and painstaking attention to detail.

Your Tour Director is a seasoned veteran who knows the ins-and-outs of the area ... the highlights, the local color ... the "extras" which can turn an ordinary event into something special. Most importantly, this friendly, experienced professional understands that you don't want to be hurried or "herded". The fact is - with the small size of your group - your Tour Director can give you personalized attention or arrange for any special service you need.

In short, no one takes better care of you than Vantage Travel. They even make the reservation process easy - by a TOLL FREE phone call and by accepting all major credit cards.

Here's just a preview of your itinerary:

AUSTRALIA - A ONE COUNTRY CONTINENT. Melbourne is the most "English" of Australia's cities, with an old-world charm punctuated by imposing Parliamentary buildings and lovely church spires. Following your arrival, take the time to stroll or photograph gracious Melbourne's many beautiful parks and gardens - including Fitzroy, with its Yorkshire cottage of the legendary Captain Cook.

From Melbourne, continue on to SYDNEY. Sydney is blessed with lovely, immaculate beaches, a bustling harbour and the enticing Blue Mountains. One of the world's most beautiful cities, it is the home of one of the most extraordinary architectural wonders anywhere - the Sydney Opera House. You will enjoy a tour of this famous showplace including a three-course dinner at the sophisticated Bennelong Restaurant.

From Sydney, get set for more wondrous sights as you fly east to one of the most beautiful countries on earth...

NEW ZEALAND ... with such magnificent and varied scenery - in an area only slightly larger than that of Great Britain! Breathtaking mountains over 10,000 feet, spectacular fjords, boiling lakes and a countryside reminiscent of Norway awaken the senses to the awesome beauty of the land.

But New Zealand is much more than tamed and untamed nature. It's one of the world's most hospitable countries - you'll agree right away!

You'll feel welcome immediately spending a relaxing evening in CHRISTCHURCH, "the most English town outside England", complete with a Gothic Cathedral, a river Avon, willow trees and 37 stone bridges.

Then, move on to QUEENSTOWN, the resort center of New Zealand. Superbly located on the shore of Lake Wakatipu, Queenstown looks out onto mountains which rival the Alps and Rockies for sheer beauty. In the absolute grandeur of New Zealand's high country, you'll take a cruise on Lake Wakatipu and tour the Cecil Peak Sheep Station. Visit a charming farmhouse and enjoy a barbeque, all while surrounded by spectacular scenery.

From Queenstown, travel overland through picturesque, peaceful countryside to TE ANAU, "gateway to the fjords". Enjoy a breathtaking cruise on Milford Sound where you will be dwarfed by awesome fjords which jut into this purest of lakes. Te Anau is also the site of the eerie subterranean Glow Worm Grotto. It is a magical, unforgettable experience, one which you will marvel over with fellow travelers.

Then it's on to ... ROTORUA, center of New Zealand's thermal area. A region of geysers, hot springs, and other natural wonders, it is also the cultural center of New Zealand's first settlers, the Polynesian Maori. You'll have the opportunity to participate in a "Hangi", the traditional Maori feast, and, while relaxing, be entertained in an evening of Maori song and dance.

You can look forward to your own special dinner with a New Zealand family in the privacy of their own home. This is a wonderful, unique opportunity to actually talk and laugh with the "Kiwis". You'll cherish this evening as one of the most memorable on this - or any other - vacation.

Last stop in New Zealand is AUCKLAND, where you will be able to spend a day collecting gifts and souvenirs as you stroll along hilly streets which provide tranquil vistas of the harbours surrounding the city.

From Auckland, fly east again - and rest up with a short overnight stay in Sydney ... then step back in time as you fly over the International Date Line and arrive in -

TAHITI - THE SOUTH SEA PARADISE. Tahiti will delight you with its tropical scenery of waterfalls and velvety green mountains. Visit the open-air market and mix with people considered by many to be the world's friendliest! The friendly natives, along with the natural magnificence of the islands themselves, inspired Gauguin to paint his most memorable work.

Enhance your trip with an extension to the magnificent tropical island of BORA BORA, dominated by two towering mountain ranges and almost totally surrounded by coral reef. A perfect conclusion to an inspiring trip. This is YOUR time - relax and enjoy some of the world's finest beaches while gazing at the deep, blue skies or swimming in the lush, green waters.

RESERVE NOW!! -- SPACE IS LIMITED -- YOU'LL BE TRAVELLING WITH A SELECT GROUP OF COMPANIONS -- JUST $300 GUARANTEES YOUR PLACE

Yes, this is that "someday" trip and you can take it now! Your amazing 18 Day/15 Night complete South Pacific vacation costs as little as $3649 from Dallas, Houston, Austin & San Antonio, departing on April 9th and 16th, 1987. Australia, New Zealand and Tahiti - a unique opportunity to experience a far corner of the world.

Make your reservation today!! THE SOUTH PACIFIC promises to be the trip of a lifetime. Call TOLL-FREE to Vantage Travel Service at 1 800-322-6677 outside Massachusetts, or 617-969-4500 within Massachusetts, or mail the reservation form in the enclosed reply envelope TODAY! You can charge your deposit to your American Express, MasterCard, or Visa credit card today. For your convenience the Reservation Center is open Monday through Friday, 8:30 am - 9:00 pm EST, Saturday, 9:00 am - 5:00 pm EST and Sunday, 12:00 noon - 6:00 pm EST.

Sincerely,

Harvey C. Byrd

Harvey C. Byrd
Grand Secretary,
Travel Chairman

P.S. Because space is strictly limited and offerred only to a select number of your group, their families and friends, reservations by necessity will be accepted only on a first-come, first-served basis. You are urged to reserve your place today - with a deposit of just $300 per person. Do it now - while you're thinking about it. And one more thing - if you reserve before October 1, 1986, you will receive a $50 reduction per person or $100 per couple off the total cost of your vacation! Offer valid only if you act before October 1, 1986.

HERE'S WHAT'S COVERED IN YOUR ALL INCLUSIVE TOUR

You don't have to worry about a thing!

- Round trip scheduled jet transportation via Qantas Airways with appropriate inflight movies, meal and beverage service.
- Deluxe hotel accommodations: 3 Nights at the Hilton International in Melbourne, Australia. 4 Nights at the Hyatt Kingsgate in Sydney, Australia. 1 Night at Travelodge in Christchurch, New Zealand. 2 Nights at the Hyatt Kingsgate in Queenstown, New Zealand. 1 Night at the Te Anau Resort Hotel in Te Anau, New Zealand. 2 Nights at the Rotorua International Hotel in Rotorua, New Zealand. 1 Day in Auckland, New Zealand. 2 Nights at the Sofitel Maeva Beach Hotel in Papeete, Tahiti.
- Pre-registration at the Hotels; all flight reservations and tickets in advance.
- Complete Travel and Tourist information prior to departure.
- A professional VTS Tour Director for the full duration of your vacation.
- Full breakfast each morning.
- Seven dinners, including a "Meet the Friendly New Zealander" Home Dinner, A Maori Hangi Dinner, A New Zealand Barbeque, and a Tahitian Feast.
- All transportation between destinations.
- A VTS hospitality desk at all destinations staffed by on-site professionals.
- Welcome Party upon arrival in Melbourne, Sydney, Christchurch, Queenstown and Papeete.
- A visit to Sydney Opera House with dinner.
- A cruise on Milford Sound (The Fjords) in South Island, New Zealand, and a visit to the Te Ana-au glow-worm grotto.
- Sightseeing in Melbourne, Sydney, Christchurch, Auckland and Papeete, a tour of Rotorua, including the Thermal Valley and Rainbow Trout Springs.
- Informative briefings on the highlights and customs of each city.
- All transfers and luggage handling between airports and hotels.
- All taxes and service charges for included features.
- A Comprehensive Travel Insurance Program has been provided as part of your tour package.
- Deluxe oversized travel bag.
- Convenient passport wallet and name badge.

A special extension to the Beautiful Island

BORA BORA

More information will be sent to you upon regsitration.

SPECIAL SAVINGS:
RESERVE BY OCTOBER 15, 1986, AND RECEIVE
A 50.00 REDUCTION PER PERSON OR $100.00
PER COUPLE.

The Most Worshipful Grand Lodge of Texas
Ancient Free & Accepted Masons

The Grand Lodge Of Texas AF & AM

Presents . . .

Adventures in Paradise

THE SOUTH PACIFIC

Australia, New Zealand & Tahiti

Exciting 18 Days & 15 Nights!

$3399* LOS ANGELES

$3649* AUSTIN/DALLAS/HOUSTON/SAN ANTONIO

See reservation coupon for additional dates and prices

ALL INCLUSIVE
PRICES GUARANTEED

Departing Thursday, April 9, 1987
Returning Sunday, April 26, 1987

Additional Departure Dates and Cities Available Upon Request.

Call TOLL FREE
1 800-322-6677
In Mass. Only: (617) 969-4500
(Vantage Travel Service, Inc.)

FOR RESERVATIONS OR MORE INFORMATION
Weekdays: 8:30 A.M. - 9:00 P.M. EST
Saturday: 9:00 A.M.-5:00 P.M. EST
Sunday 12 noon-6 P.M. EST

SPACE IS STRICTLY LIMITED!
SO RESERVE TODAY.
Complete the easy Priority Booking form on reverse side and return it in the reply envelope. Take a minute to do it — NOW!

*Per person based on double occupancy

PRIORITY BOOKING/SPACE REQUEST

RESERVATIONS FOR SOUTH PACIFIC
The Grand Lodge of Texas AF & AM

1 PERSONAL INFORMATION

Name(s) ______________________
Address ______________________
City/State/Zip ______________________
Home Phone (____) ________ Bus. Phone (____)________
I/we have read the tour participant agreement and agree to its terms
Signature ______________________

2 PAYMENT PLAN — SELECT THE ONE THAT'S BEST FOR YOU

Minimum deposit of $300 per person. Full payment is due 60 days prior to departure. For reservations made within 60 days of departure, full payment is due immediately.
Deposits can be charged to your credit card.

☐ I will pay by check
Amount of deposit $ ____________ # of persons________
☐ Full payment in the amount of $________
Make check payable to SOUTH PACIFIC ADVENTURE
☐ I will pay by credit card.
Amount of deposit $ ____________ # of persons________
☐ Full payment in the amount of $________
☐ Mastercard ☐ Visa ☐ AmEx
Card # ______________ Exp. Date________
Name on card ______________________

3 Please confirm the following reservations

	DEP. DATE	DEP. CITY	PRICE		DEP. DATE	DEP. CITY	PRICE
☐	Thurs., Jan. 22, 1987	Los Angeles	$2790	☐	Thurs., Apr. 9, 1987	Los Angeles	[illegible]
☐	Thurs., Jan. 22, 1987	Austin	[illegible]	☐	Thurs., Apr. 9, 1987	Austin	[illegible]
☐	Thurs., Jan. 22, 1987	Dallas	[illegible]	☐	Thurs., Apr. 9, 1987	Dallas	[illegible]
☐	Thurs., Jan. 22, 1987	Houston	[illegible]	☐	Thurs., Apr. 9, 1987	Houston	[illegible]
☐	Thurs., Jan. 22, 1987	San Antonio	[illegible]	☐	Thurs., Apr. 9, 1987	San Antonio	[illegible]
☐	Thurs., Feb. 26, 1987	Los Angeles	$2790	☐	Thurs., Apr. 16, 1987	Los Angeles	[illegible]
☐	Thurs., Feb. 26, 1987	Austin	[illegible]	☐	Thurs., Apr. 16, 1987	Austin	[illegible]
☐	Thurs., Feb. 26, 1987	Dallas	[illegible]	☐	Thurs., Apr. 16, 1987	Dallas	[illegible]
☐	Thurs., Feb. 26, 1987	Houston	[illegible]	☐	Thurs., Apr. 16, 1987	Houston	[illegible]
☐	Thurs., Feb. 26, 1987	San Antonio	[illegible]	☐	Thurs., Apr. 16, 1987	San Antonio	[illegible]

4 SPECIAL OPTIONS

☐ I want more information on the Bora Bora Extension.
☐ I desire to have a single hotel room. Add $500.00 to my payment.
☐ I want a third person in a room reduction. Deduct $250.00 off total tour price.
☐ If possible, I/we would like to be adjacent to: ____________
☐ Non-smoking Section ☐ Smoking Section
☐ 1st Class air transportation prices are available upon request.
☐ I am sharing my room with ______________________

Completing this form is as easy as 1, 2, 3. It takes just a few moments of your time. When you have completed all sections, detach this form where indicated and return this upper portion in the reply envelope provided.
MAKE SURE THAT THIS ADDRESS SHOWS THRU "WINDOW" IN RETURN ENVELOPE.

The Grand Lodge of Texas AF & AM
P.O. Box 446
Waco, Texas 76703

THIS ADDRESS SHOULD SHOW THRU WINDOW IN RETURN ENVELOPE

[illegible] PRIORITY
RESERVATIONS BY PHONE,
Just CALL TOLL FREE
[illegible]-6677
In Mass. Only ([illegible]) 969-[illegible]
(Vantage Travel Service, Inc.)
FOR RESERVATIONS OR MORE INFORMATION
Weekdays [illegible] A.M.-[illegible] P.M. EST
Saturdays [illegible] A.M.-[illegible] P.M. EST — Sunday 12 noon-6 P.M. EST

SPACE IS LIMITED!
FIRST COME . . . FIRST SERVED!

RETURN THIS PRIORITY RESERVATION FORM NOW.

Please print all requested information.
If more than one couple, attach separate sheet with complete information as at left. **You will receive detailed pre-trip and planning information shortly after returning this form.**

(DETACH HERE AND RETURN UPPER PORTION IN ENVELOPE PROVIDED) F 1

✂ - ✂

TOUR PARTICIPANT AGREEMENT

Reservations/Final Payments/Cancellations: Reservations are confirmed upon receipt of a deposit of $300 per person. Final payment must be made at least 60 days before your departure. Prices stated are per person and based on double occupancy. Single supplement is $500.00. Child reductions are available upon request. Third person in a room deduct $250.00 off total tour price. There are no quads available. In the event it becomes necessary for you to cancel your reservation, there will be a handling fee of $25 per person for cancellation received more than 60 days prior to departure. The charge for cancellation from 59-0 days before departure is $300 per person. Requests for refunds or cancellations must be made in writing or by telegram.

Travel Insurance Program: A Comprehensive Travel Insurance Program has been provided as part of your tour package.

For complete details concerning the coverages, benefits, exclusions, pre-existing conditions and provisions included in this program, please refer to the "Description of Coverage". The "Description of Coverage" will be furnished with your trip invoice or travel documents upon your initial tour payment. In addition, please examine this "Description of Coverage" carefully prior to departure to determine if additional insurance is required.

Travel Documents: A valid passport is required for everyone, regardless of age and may be obtained or renewed at any U.S. District or Superior Court or Passport Office. Your Post Office can assist and direct you on the necessary procedures. U.S. Citizens also need a Visa for Australia. Visa information will be sent to you upon receiving deposit.

Non-U.S. Citizens should check with their embassy for information regarding their necessary travel documents.

Taxes and Tips: Baggage handling, hotel taxes, and tips to chambermaids are included. Tips to guides, escorts and drivers are not included. Note: Tipping is not customary in Tahiti.

Not Included: Items of a personal nature such as laundry, valet, room service, telephone, additional food and beverage, tips to guides or Tour Director and any items not specifically listed in the included features.

Overnight in Gateway City: Due to limited airline connections, passengers may be overnighted in gateway or assembly city.

Responsibility: Vantage Travel Service, Inc., its affiliated and/or sponsoring organizations* and agents, act ONLY as agents for the suppliers or contractors of the services described herein, including, but not limited to airlines, suppliers of hotel and/or cruise accommodations, transportation and other tour related services. Agents shall not be responsible or liable for any delays, loss or injury to person or property due to any cause occurring during the tour.

The Agent reserves the right to alter any part of the itinerary, including, but not limited to, hotel or cruise accommodations or airlines without notice. In the event alteration in the itinerary or accommodations becomes necessary, substitutions will be of comparable quality. The Agent reserves the right to (i) cancel the tour at any time prior to departure and refund all monies in full settlement of its obligations, and (ii) decline to accept or retain any person as a member of the tour.

The cost of this vacation package is based on group promotional tariffs and foreign exchange rates in effect as of April 1986.

Enrollment in this trip constitutes agreement to the provisions stated.

*The above Responsibility Clause also applies to the sponsoring organization.

Midwest Travel King, Inc.
218 WASHINGTON STREET
WAUKEGAN, ILLINOIS 60085
PHONE (312) 336-8200
TELEX 754292MTK

April 6, 1987

Harvard Alumni Association
Wadsworth House
Cambridge, MASS 02138
Attn: James A. Quitslund, Program Director

Dear Mr. Quitslund:

I have a copy of the Travel Study Program you are offering that includes the voyage to Scandinavia, etc. I would like to ask you two questions.

1. What is there about this trip that would qualify it for nonprofit postage? There is a travel tour operator involved and travel tour operators, to the best of my knowledge, do not operate in a charitable manner other than they try to be nice to tour organizers. Everything they do is aimed at making a profit. If Harvard isn't making a profit and the tour operator isn't making a profit then the nonprofit stamp would be satisfactory but if someone is making a profit, I don't think a nonprofit stamp is the right approach. Personally I have appeared before a Congress ordered Special Investigating Committee on the general subject of postage. It seems to me that someone should be paying the proper postage on this flyer, at least a bulk mail amount. Most people do not realize, and perhaps you don't that for every nonprofit piece of mail the post office handles, Congress has to make up the difference between the small amount paid and regular postage and that means those of us who are in the general field and who are paying our taxes are being taxed again to pay for competitive literature.

2. Other than the normal wording of a travel itinerary, what is there about this trip that makes it a true "study tour"?

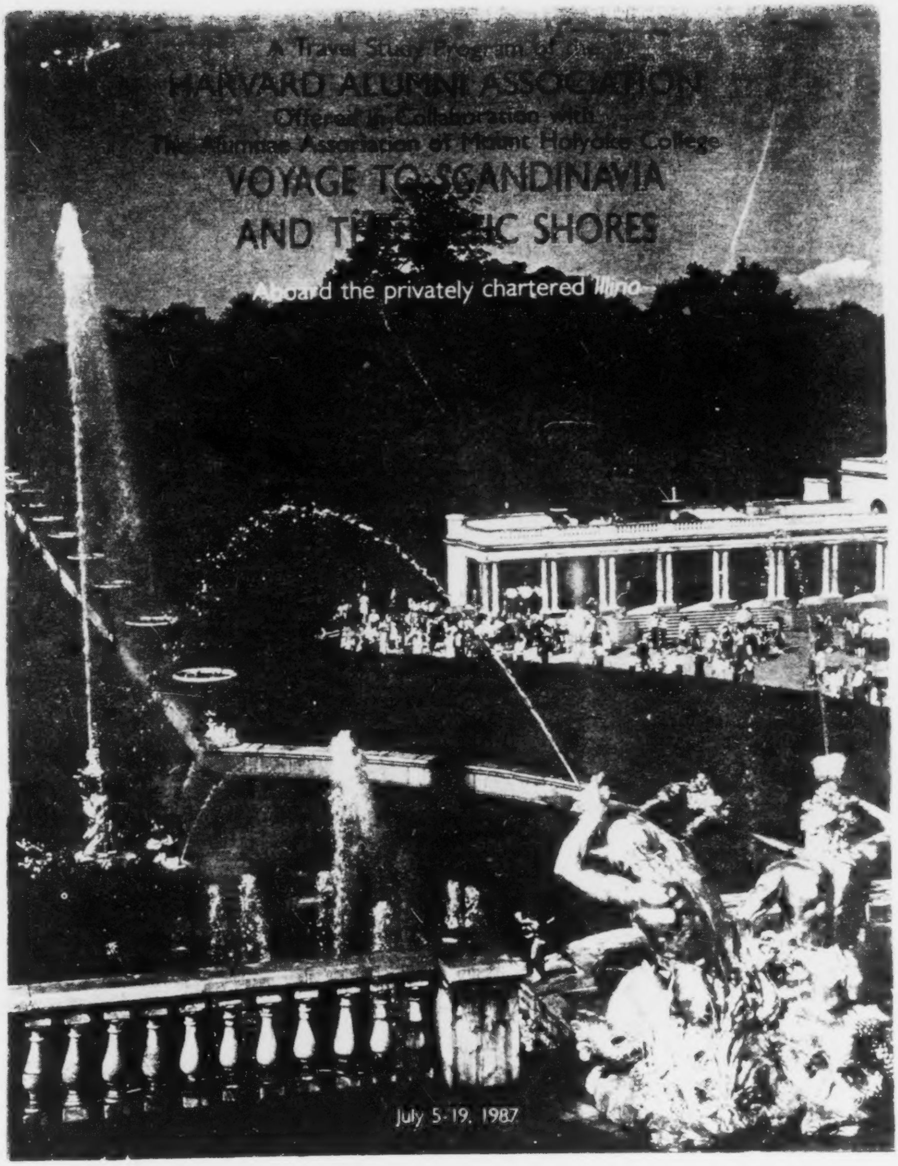
I also would like to know how booking through Travel Dynamics directly qualifies one for a $300. per person reduction. And how would one find Travel Dynamics?

I realize my eye skips over the fine print of general information on brochures because they all seem alike to me but I don't find Travel Dynamics address anyplace on this brochure.

I am looking forward to your response with great interest.

Yours truly,

Morton R. Mann CTC
MRM:sjp
cc: Barbara O'Hara / 2m MBA 39



A Travel Study Program of the

HARVARD ALUMNI ASSOCIATION

Offered in Collaboration with

The Alumnae Association of Mount Holyoke College

VOYAGE TO SCANDINAVIA

AND THE BALTIC SHORES

Aboard the privately chartered *Illiria*

July 5-19, 1987

ITINERARY

Sunday, July 5
Departure from the United States
We leave New York on a regularly scheduled direct flight bound for Stockholm. Connecting service from other North American cities will be arranged on request at the applicable additional fare.

Monday, July 6 through Thursday, July 9
Stockholm, Drottningholm, Uppsala and Sigtuna
We arrive in Stockholm on the morning of July 6 and transfer directly to the *Grand Hotel*, where we have accommodations for three nights.

We shall have the first afternoon at leisure; in the early evening a cocktail reception will be hosted by the lecturers and a senior alumni affairs officer from the University.

Stockholm is one of the great cosmopolitan centers of the world, offering us beautifully preserved reminders of the Middle Ages, monuments reflecting the wealth and pride of Sweden's "imperial" era and the results of the social and aesthetic experiments of the last one hundred years.

During our time in Stockholm we shall offer two optional excursions outside the city itself.

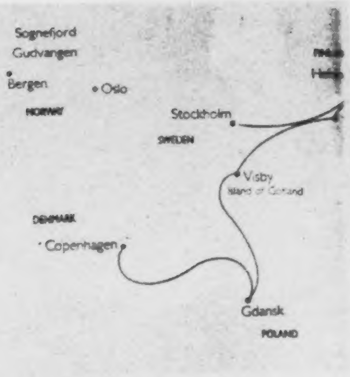
One excursion gives us the opportunity to visit the splendid lakeside palace and grounds at Drottningholm, the principal summer residence of the Kings of Sweden since the late 17th century.

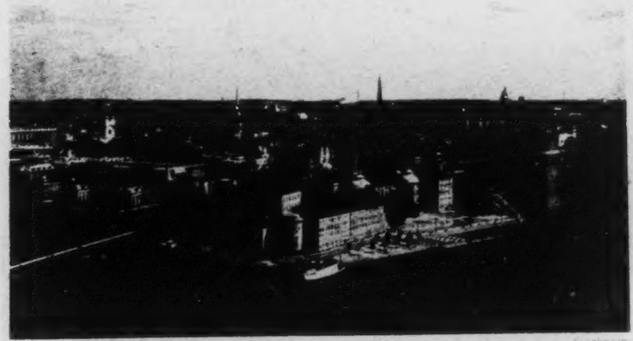
The second excursion is devoted to Uppsala and Sigtuna. Uppsala's importance was established in pagan times, when it was the political and religious center of the ancient kingdom of Svea. Its significance as Sweden's oldest ecclesiastical center is expressed in its cathedral, related through its architect to Notre Dame in Paris and consecrated in 1435. The library of the University holds treasures including the richly illuminated Gothic "Silver Bible" that was brought from Prague as booty by the Swedish forces in 1648, at the end of the Thirty Years War. We return to Stockholm by way of Sigtuna, a town known for its medieval churches and its picturesque setting on the edge of Lake Malaren.

On the afternoon of Thursday, July 9 we board the *Illiria* and cruise out through the Archipelago into the Gulf of Finland.

Friday, July 10
Helsinki
The *Illiria* docks near the Market Square in Helsinki in the morning. The history of Finland is a story of centuries of domination by the Swedes and the Russians. The modern state of which Helsinki is the capital was established in 1917. "The white city of the north" is characterized by the contrast between monuments that conform to the standards of north-European traditionalism (Senate Square, the Villa Meile) and the work of such specifically Finnish artists as Alvar Aalto (1898-1976) and Eliel Saarinen.

Following luncheon on board the ship, the *Illiria* sails in the mid-afternoon.





Stockholm

Saturday, July 11 and Sunday, July 12
Leningrad
Leningrad was founded in 1709 by Peter the Great on the banks of the Neva River; the city was to be his empire's naval fortress, shipyard and "window on Europe." From 1712 until March 1918 St. Petersburg was the czarist residence. It is one of the world's most beautiful cities, a living museum of 18th-century Neoclassicism. Here too are monuments to the social revolutions: Decembrists' Square, the cruiser Aurora from which the signal was given for the storming of the Winter Palace, and the Smolny Institute in which Lenin hid while planning the Bolshevik coup. Today Leningrad rivals Moscow as an academic, intellectual and cultural center.

Our time in Leningrad will be devoted primarily to the exploration of the two centuries of the city's pre-revolutionary history. Sites to be visited will be selected with great care and will be studied in greater depth than standard tourist itineraries allow.

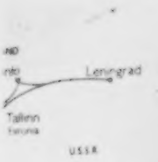
The monuments within the city will include the Peter and Paul Fortress and the ensemble that extends from Falconet's statue of Peter the Great to the Admiralty and the Winter Palace. Our visit to the Hermitage will be planned to allow individuals an opportunity to concentrate on the facets of the huge collection that hold special interest for them. We shall also offer a visit to the Alexander Nevsky Lavra with its active Orthodox cathedral and the Necropolis which contains the tombs of many of the great writers and musicians of 19th-century Russia.

We shall also offer a choice of visits to the famous royal residences outside the city. One of these is Petrodvorets, Peter the Great's summer Palace on the Gulf of Finland. The other excursion takes us south of the city to visit the palace and park near the town formerly known as "Czar's Village" and now named after the poet Pushkin, who attended school there.

On July 11 we shall offer an optional evening with dinner and entertainment in one of Leningrad's well-known restaurants.

Monday, July 13
Tallinn, Soviet Estonia
We arrive in the morning at Tallinn, a city that dates back to the 11th century. Known as Reval, the town and its environs were occupied by Danes, Livonian Knights, Swedes and Russians. It was the Danes under whom the town prospered as one of the major Baltic trade centers, and it is the Danes to whom the town's present name refers.

Tallinn is one of the best preserved medieval cities of Northern Europe and fortunately escaped devastation during the Second World War. Among its most imposing individual monuments are the Dome Church in the Upper Town (Toompea) and the City Hall, Holy



Royal Guard, Amalienborg Palace, Copenhagen

Great Church and Great Guild Hall [illegible], which houses the Estonian State Museum.

[illegible]

Visby, Gotland

Morning arrival at the port town of Gotland, Sweden's largest island. Gotland was involved in international trade as early as the Roman Age. During the Middle Ages the peasant traders of the island even had a trading house at Novgorod in Russia; this made them powerful intermediaries between the Russian interior and Western Europe. [illegible] Gdansk, was an integral part of the network of commercial and communication which extended to Byzantium and the Islamic world. In the 13th century Visby was the center of the newly founded Hanseatic League. The town and the island as a whole are of great artistic and [illegible].

[illegible]

Gdansk, Poland

Morning arrival at Gdansk. The town was mentioned in chronicles as early as 997. The strategic significance of its position and its harbor were recognized by the Teutonic Knights, who conquered the town in 1308 and held it for a century. By the end of the 15th century Gdansk was one of the most powerful economic centers on the Baltic. The architectural projects undertaken during this period also made it one of the most beautiful cities of the North. Profound loyalty to Poland and the traditions of Polish culture helped keep the town independent until the power of Prussia overwhelmed and systematically "Germanized" all of Pomerania. Following the end of the First World War Gdansk was a demilitarized Free City; since 1945 it has, of course, been one of the chief centers of Polish culture, industry and [illegible].

We shall have an opportunity to explore many of the characteristic medieval and Renaissance monuments of the Old Town, which has been lovingly restored since Poland's liberation at the end of the Second World War.

[illegible]

Copenhagen, Frederiksborg, Kronborg

[illegible] Copenhagen on the morning of [illegible]. The name means "merchants' harbor," and it was the harbor that was the key to the city's evolution from a small fishing village to the capital of Denmark and one of Europe's most colorful and lively cities.

We have accommodations for three nights at the [illegible] and centrally located [illegible].

[illegible] to explore Copenhagen during a stay lasting only a few days. Our program will offer us an opportunity to explore in some depth a number of the city's famous landmarks and institutions.

Copenhagen is rich in castles, and we shall review the role of the aristocracy in the history of Denmark's rise to prominence in Europe as we visit the royal residences of Rosenborg, Amalienborg and Christiansborg.

Copenhagen has two world-renowned museums. The National Museum is dedicated to Danish history and ethnography and also houses a fine collection of classical art. The New Carlsberg Glyptotek, founded in 1882 by Dr. Carl Jacobsen, the brewer, has one of Europe's great collections of sculpture; in this collection works by Danish artists of the 19th and 20th centuries are of particular interest.

We shall also devote some attention to a small museum that is passed over by conventional tourist itineraries. It is the Thorvaldsen Museum, which occupies a handsome neo-classical building and displays representative works in various media by Bertel Thorvaldsen, Denmark's most famous sculptor.

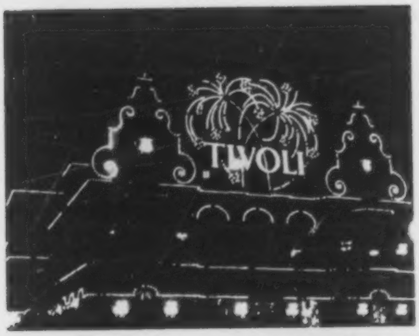
We shall offer one optional excursion beyond the city limits. It takes us north of the city [illegible] to the [illegible] of Frederiksborg and then to the [illegible] of North Zealand. There we shall visit the [illegible] and the castle of Kronborg at Helsingør (Elsinore), the setting for the [illegible] Shakespearean [illegible] Hamlet.

[illegible]

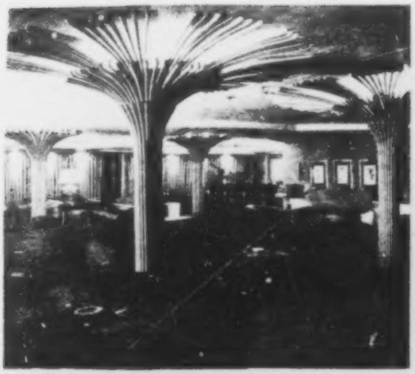
Return to the United States

Morning transfer to the airport for our regularly scheduled flight to New York. The flight arrives in midafternoon, for connections to other cities.

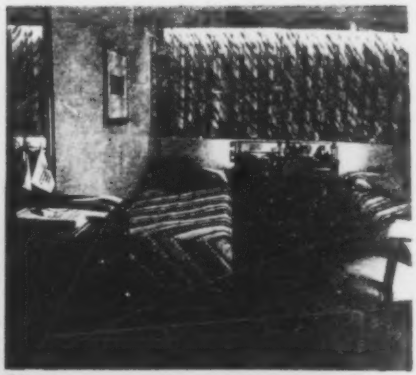
Tivoli at Night, Copenhagen



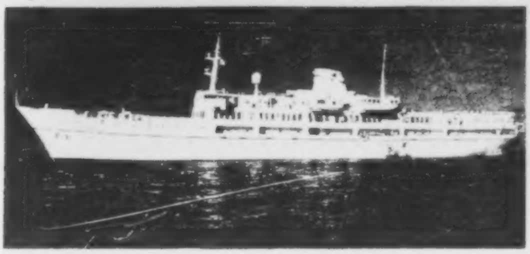
Visby, Gotland



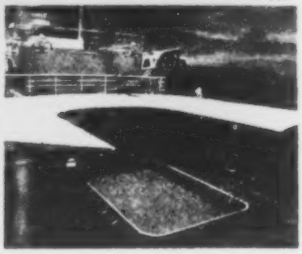
Lounge ▲



Cabin ▲



▼ Lido Deck



THE ILLIRIA [illegible]

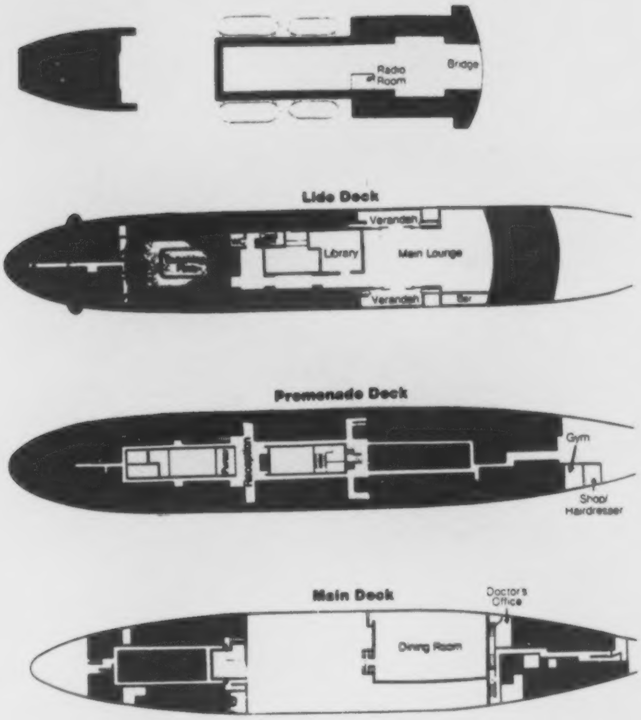
[illegible]

Foyer ▼

Dining Room ▼

Library ▼

DECK PLAN


Radio Room
Bridge
Lido Deck
Verandah
Library
Main Lounge
Verandah
Bar
Promenade Deck
Reception
Gym
Shop/ Hairdresser
Main Deck
Doctor's Office
Dining Room

PROGRAM INCLUDES

- Three nights at the *Grand Hotel* in Stockholm and three nights at the *Hotel d'Angleterre* in Copenhagen, with Scandinavian breakfast daily.
- Cruise on board the privately chartered *Illiria*.
- Sightseeing tours in Stockholm and Copenhagen as described in the itinerary.
- Series of lectures by accompanying guest lecturers.
- Welcome cocktail reception at the hotel in Copenhagen.
- All meals during the cruise—American breakfast, lunch, dinner, afternoon tea, and midnight snack. Lunch on full-day excursions.
- Travel Dynamics Trip Director to assist you throughout the trip, as well as Travel Dynamics cruise staff aboard the *Illiria*.
- Transfers between airports, piers, and hotels for those traveling on group flights; baggage handling abroad.
- Airport taxes, embarkation taxes, and service charges. Gratuities to drivers and guides on excursions.

NOT INCLUDED: Airfare; passport expenses; accident and baggage insurance; meals other than those specified above; personal expenses such as laundry and telephone calls and cables, and alcoholic beverages ordered at table. SHORE EXCURSIONS DURING THE CRUISE ARE OPTIONAL AND ARE NOT INCLUDED.

RATES

Types of Accommodations All cabins have a private bath with shower. Deluxe staterooms have a private bath with tub and shower.	**For One Person**	**Each of Two Persons**
Type D Inside cabins with two lower beds. 58, 70, 71, 72, 73		$2,695
Type DD Inside cabins with two lower beds. 40, 41, 42, 43, 44	$4,295	$2,795
Type C Outside cabins with two lower beds. 50, 51, 52, 53, 54, 55		$3,195
Type CC Outside cabins with two lower beds. 11, 12, 56, 57, 66, 67, 68, 69		$3,495
Type B Outside cabins with two lower beds. 9, 10, 14, 15, 20, 21, 22, 23, 30, 31		$3,795
Single outside cabins with one lower bed. 32, 33	$5,295	
Type BB Outside cabins with two lower beds. 1, 2, 60, 61, 62, 63, 64, 65		$3,995
Type A Outside cabins with two lower beds. 3, 4, 5, 6, 16, 17, 18, 19, 28, 29		$4,095
Type AA Outside cabins with two lower beds. 24, 25, 26, 27, 34, 35, 36, 37, 91, 92, 93, 94, 95		$5,195
Single outside cabins with one lower bed and upper berth. 90, 96, 97, 98, 99 (Also available for two persons at $3,795 per person.)	$5,695	
Deluxe Outside cabins with two lower beds and sitting area. 7, 8		$6,395

Above rates do not include airfare, which from New York is $973 as of January, 1987.

SPECIAL PRICE REDUCTION

BOOK YOUR TRAVEL ARRANGEMENTS THROUGH TRAVEL DYNAMICS AND RECEIVE A $300 PER PERSON REDUCTION ON THE TRIP COST. You may depart from your home city at applicable domestic airfare. Airfare may be charged to American Express, Visa, or MasterCard. First and business class air arrangements are available on request.

REGISTRATION

Make check payable to "Harvard Alumni Association" and mail to:

Continuing Education
Harvard Alumni Association
Wadsworth House
Cambridge, Massachusetts 02138

Enclosed is my check for $________($750 per person) as deposit to hold ______place(s) on *Voyage to Scandinavia and the Baltic Shores*, July 5-19, 1987. I understand that final payment is due sixty (60) days prior to departure.

My first, second, and third choice of accommodations are:

Type D	________	**Type DD**	________	**Type C**	________
Type CC	________	**Type B**	________	**Type BB**	________
Type A	________	**Type AA**	________	**Deluxe**	________

☐ I wish single accommodations, Type__________.

☐ I wish to share if share can be arranged.

☐ Smoker ☐ Nonsmoker

Name(s) ____

____

Address____

City ______________________ State _____ Zip________

Telephone: Home (   ) ____________ Office (   ) ____________

Harvard Affiliation(s) ______________________________ 736B

Harvard Alumni Association

THE PROGRAM

The itinerary which we have arranged for this program begins in the center of the realm that the Romans called the *mare balticum*. Our easternmost port call is on the Neva, one of the many rivers that link the heartland of Eastern Europe to the sea, and the program ends with three days on the Danish island of Zealand, which belongs not only to the Baltic but to the North Sea and the Atlantic beyond.

As the era of Mediterranean hegemony gave way to the social, economic and cultural pluralism of the early Middle Ages, the Indo-European peoples to the north and east of the Romanized lands—the Angles and Saxons, Goths, Balts, Slavs—emerged and engaged in movements and interactions that did much to set the course of later European history. We all learned in school about the Normans, the "men of the north," and their impact on France, the British Isles and the Central Mediterranean. The westward expansion of the Vikings is balanced by the reinforcement of the Scandinavian presence along the inland waterways that linked the Baltic to Byzantium and also to the Arab trade routes to the Caspian Sea and Orient.

By the end of the first millennium the Baltic was established as a vital center of a huge network of trade and communication. By the 17th century the coastal settlements and the societies they fostered possessed material wealth, civic pride and internal stability. They set the standards that Peter the Great had in mind when he drafted his plans for a new capital on the Neva.

During the course of our tour we shall visit ports that tell the various chapters of this story. In Old Uppsala we shall see the remains of the capital of the pagan kingdom of Svea. On the island of Gotland, in Tallinn and in Gdansk we shall see different facets of northern civilization of the Middle Ages and the Renaissance. In Helsinki we shall appreciate the special achievements of the youngest member of the Baltic community of nations. And during the time we devote to Stockholm, Leningrad and Copenhagen we shall become familiar with art, architecture and vistas that express both the grandeur and the diversity of the living traditions of European culture.

James A. Quitslund '63, Program Director
Harvard Alumni Association
Wadsworth House
Cambridge, Massachusetts 02138
(617) 495-5342

APR 27

MINNESOTA
ALUMNI
ASSOCIATION

April 15, 1987

Mr. William B. Craig
6701 Galway Drive
Edina, Minnesota 55435

Dear Mr. Craig:

The University of Minnesota Alumni Association board of directors concurs with the sentiments you expressed in your letter of April 10, 1987. The use of the nonprofit mail permit is a privilege and should not be taken for granted or abused.

The University of Minnesota Alumni Association and the other Big Ten alumni institutions continue to believe that travel programs of an educational nature are an appropriate service to members.

The use of the nonprofit mail permit is still a gray area for certain programs of nonprofit organizations, including travel. The postal rate commission as recently as June 1986 was studying the issue to provide clarity for all nonprofits (see attached). Last summer, the Big Ten alumni directors began serious deliberation on this issue.

I note that you and your wife, Norma, were Association members from 1975-79. We would certainly like you to reaffiliate so you would have more direct access to our current activities. I've enclosed current information in the hope that you will reaffiliate. Regardless, I would enjoy the opportunity to discuss this issue further if you choose.

Please keep in touch.

Sincerely,

Margaret Carlson

Margaret Sughrue Carlson
Executive Director

MSC:kmf

cc: Harvey B. Mackay, National MAA President
President Kenneth H. Keller
Regent Charles McGuiggan

100 MORRILL HALL 100 CHURCH ST. S.E. MINNEAPOLIS, MN 55455 612/624-2323

GROSSE POINTE WAR MEMORIAL ASSOCIATION
presents

Virgin Islands

The Caribbean Cruise in the Yachting Tradition

Aboard the 100-passenger luxury yacht *Newport Clipper*
U.S. registry and crew
visiting:
St. Thomas · St. John · St. Croix · Tortola
Norman Island · Virgin Gorda · Salt Island

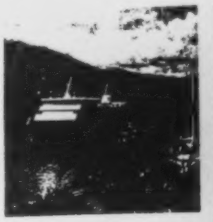
Sunday, February 15—Sunday, February 22, 1987

The Yachtsman's Caribbean at its Best

The all-new, all-American luxury yachts from Clipper combine the comfort of an opulent passenger liner with the intimacy and exclusivity of a private yacht. These sleek vessels visit out-of-the-way yacht harbors and calm bays where no large cruise ship can navigate, making available in an elegant, relaxed and uniquely personal way what National Geographic calls "some of the world's most beautiful waters."

With just 100 other passengers, you'll share a spirit of adventure touched with elegance as your Clipper yacht retraces centuries-old island routes charted by Spanish conquistadors, Dutch settlers and English pirates.

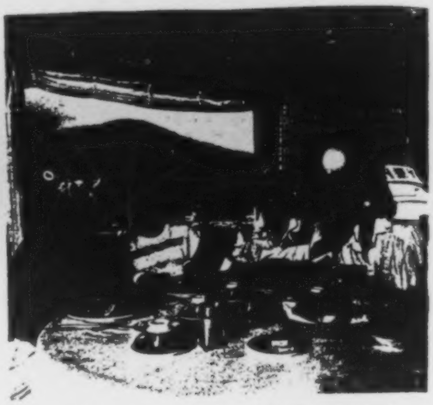
Visit uncrowded beaches where you'll virtually step right onto the sand from your ship. And when you're not sightseeing, swimming or just plain beachcombing, there's time for learning to windsurf, sail or even take a scuba resort course. The choice is yours. Clipper wants you to enjoy this tropical paradise exactly as you please.



Welcome Aboard your Clipper Luxury Yacht

As you step aboard Clipper's sleek and impeccably maintained vessels, you'll find their graceful lines preface to the elegance found within. Subtle pastel colors, handcrafted, light-toned woods and original works of art handsomely accent the interior areas including the 51 luxurious staterooms of each yacht.

Choose from four stateroom arrangements, all tastefully decorated and furnished with twin lower beds. Each offers an outside view, generous wardrobe and drawer space, thoughtful personal appointments and private bathroom with shower.

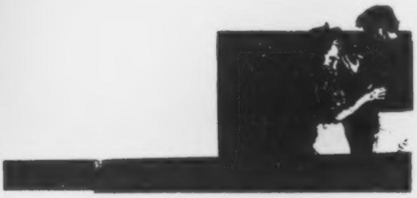


The elegant window-lined dining room complements the bounty of Clipper's excellent American cuisine. Your three chefs — all graduates of the prestigious Culinary Institute of America — appease hearty appetites and discriminating palates alike with a choice of enticing specialties. And the leisurely single seating for all 100 guests makes your discussion of the day's activities all the more pleasurable.

In the glass-walled Observation Lounge and Bar, guests gather to socialize, play cards and backgammon, enjoy light entertainment or watch the ever-changing scenery. On Clipper, you avoid the hectic atmosphere of large cruise ships and enjoy instead a sense of gracious privacy akin to that of an intimate club.

Outside, spacious, hand-laid teakwood decks crown your luxury yacht, inviting you to unwind in the caress of sun and gentle sea breezes.

From the first "welcome aboard," you'll be served by a friendly young American crew whose charm and energy are the heart and soul of the Clipper experience.



Here's What is Included:

- Your cruise aboard Clipper as per itinerary.
- All staterooms are outside, fully air-conditioned, with three-channel music and private bathroom facilities.
- Enjoy a choice of fine American specialties. Three delicious meals daily, each served at one leisurely seating.
- Cruise director on board to assist you.
- Friendly and efficient all-American crew to serve you.
- Snorkels, masks and fins provided at no charge.
- Welcome Aboard and Captain's Farewell cocktail parties including hot and cold hors d'oeuvres.

**GROSSE POINTE
WAR MEMORIAL
ASSOCIATION**

32 LAKE SHORE DRIVE
GROSSE POINTE FARMS, MICHIGAN 48236-3726
313/881-7511

The Grosse Pointe War Memorial offers you the exclusive, *uncrowded* way to experience the culture, history and tropical splendor of the Caribbean—luxury yachting through the U.S. and British Virgin Islands.

You'll see this lush, mountainous paradise as only a yachtsman can...visiting tiny aquamarine harbors and out-of-the-way bays where large cruise ships never call. Enjoy sparkling, white sand beaches and sunny skies; swim and snorkel in the crystal-clear waters. Learn about the history of these islands and take advantage of duty-free shopping.

The all-American *Newport Clipper* will be your floating luxury hotel for the week, featuring beautifully decorated, all-outside staterooms, an elegant—yet casual—one-seating dining room, glass-walled Observation Lounge and spacious teakwood sundecks. A smiling all-American crew makes you feel at home and is dedicated to your comfort and well-being.

We invite you to attend a travel information night at the War Memorial, Thursday, September 25, 1986 at 7:00 p.m. Questions you may have will be answered, and we'll also view Clipper's video adventure which takes us through "the world's most beautiful waters," where secluded harbors and a vast array of water-sports await us.

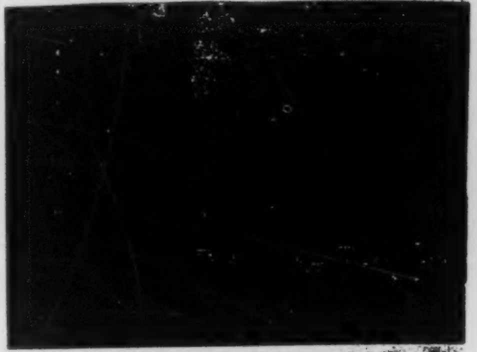
For reservations, return the coupon on the back of this brochure with your deposit.

Make your plans now to explore the Virgin Islands in the yachting tradition, aboard the *Newport Clipper.*

Itiner

Day	From/To
Sunday	Crown Bay, St. Thomas (embark 4 p.m.)
Monday	Depart St. Thomas 7 a.m., arrive Cruz Bay, St. John 1 p.m.
Tuesday	Depart St. John 1 a.m., arrive Christiansted, St. Croix 7 a.m.
Wednesday	Depart St. Croix 1 a.m., arrive Road Town, Tortola 7 a.m., depart Tortola 1 p.m., arrive Norman Island 3 p.m.
Thursday	Depart Norman Island 6 a.m., arrive Leverick Bay, Virgin Gorda 9 a.m.
Friday	Depart Virgin Gorda 6 a.m., arrive Salt Island 9 a.m., depart Salt Island 2 p.m., arrive Sopers Hole, Tortola 4 p.m.
Saturday	Depart Tortola 8 a.m., arrive Charlotte Amalie, St. Thomas 11 a.m.
Sunday	Depart Charlotte Amalie 7 a.m., arrive Crown Bay 8 a.m. (disembark 10 a.m.)

Chart your course for Clipper's Virgin Islands!



The exotic beauty of this paradise in the Caribbean is apparent as you approach the Virgin Islands: a multitude of lush mountainous islands rise amber and green against a glistening sea whose colors run from turquoise to royal blue. It's only a prelude to the beautiful scenery and recreational opportunities that await you as your Clipper yacht readies to visit secluded bays and marinas, places the private yachts have had to themselves for years.

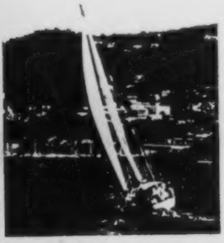
From bustling St. Thomas, we'll set a course through the islands, on sea lanes that once bore the treasure fleets of Spain. There's time for a refreshing swim before lunch, as your Clipper yacht drops anchor in a quiet cove along St. John's beautiful shores. Our sheltered anchorage is only yards from coral reefs teeming with colorful tropical fish ... perfect for snorkeling right from the side of the ship (we'll provide the snorkels, fins and masks).

Tortola, capital of the BVI, offers some magnificent beaches, or an afternoon's perusal of **Road Town,** down winding lanes lined with three-century-old Dutch stone architecture, now converted to interesting shops. Anchor under the stars this evening at uninhabited **Norman Island,** the inspiration for Robert Louis Stevenson's *Treasure Island.*

Cruising northeast within the protected Sir Francis Drake Channel, we'll pass islands — Fallen Jerusalem, Beef, Ginger, Dead Chest, Great Dog — whose names insist you're off the usual, big cruise ship circuit. We dock at **Leverick Bay, Virgin Gorda** where you can explore *The Baths,* a snorkeler's paradise amid house-size boulders piled atop a white sand beach, forming hidden grottos and crystalline pools. For the more adventuresome, there are opportunities at Leverick Bay for scuba diving or renting a sailboat for the day. Even parasailing awaits those who prefer a bird's eye view of the beautiful environs.

From our **Salt Island Bay** anchorage, take a ride in a glass-bottomed boat and view the wreck of the *Rhone,* a British mail ship sunk in 1867. Experienced scuba enthusiasts will have time to investigate it alongside the fish that inhabit this popular dive site. Evening will find your Clipper yacht at **Sopers Hole** on **Tortola's West End;** it's a popular yachtsman's harbor where the tales are tall and the limbo sticks low!

St. Croix, largest of the U.S. Virgin Islands, was discovered by Columbus in 14[illegible] and traces of the past survive [illegible] the old forts, plantation house ruins and shady Danish arcades [illegible] the two towns of **Christiansted** and Frederiksted.



Top photo & right: Anchor under the stars in the style of a yacht, and experience some of the most spectacular sunsets anywhere.

Above: Your cruise begins and ends in Charlotte Amalie, with Clipper's waterfront dock conveniently located near duty-free shops and island nightlife.

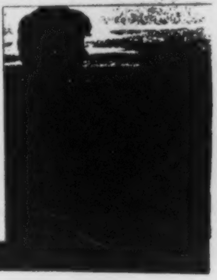
Left: Enjoy a dip in the fresh-water pool at Leverick Bay, Virgin Gorda.

For the snorkeler, Buck Island's [illegible] encircling coral reef provides calm, clear waters, inquisitive tropical fish and an underwater snorkeler's trail.

St. John welcomes you with photogenic mountain vistas within its 6,000-acre U.S. National Park, Caneel Bay Plantation and picturesque Trunk Bay, the ideal spot for swimming and sunning along its sugar-sand beach lined with palms. If you prefer, explore the island by rental jeep or motorbike from our dock at **Cruz Bay.** The angler can find excitement for the day with a deep-sea charter boat, perhaps tangling with a blue marlin, sailfish, tarpon or permit.

Following a short cruise back to **St. Thomas,** your Clipper yacht docks in downtown **Charlotte Amalie,** just one-half block from the Caribbean's finest shops. And with duty exemptions at $800 per person — twice that of any other island or foreign country — you'll enjoy shopping for jewelry and precious metals, china, crystal and camera equipment.

Itinerary of either Clipper yacht may be reversed subject to marina berth availability.



Clipper Experience: Physically Rewarding

Clipper makes available in a relaxed and hassle-free way some of the finest recreational activities in the Virgin Islands. Perfect for the traveler whose vacation plans include keeping fit, but exclude the often-corny and regimented mass-oriented "fun and games" of the large cruise ships. Best of all, the maneuverability of Clipper's luxury yachts gives you access to a broad range of recreational opportunities; you're never limited to a single locale or resort.

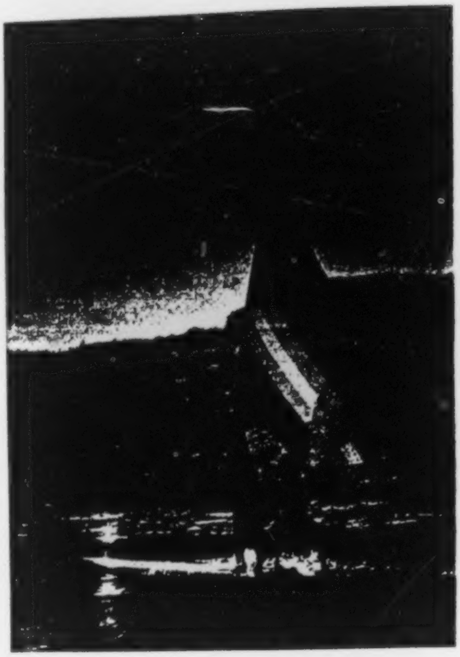
In the Virgin Islands a **vast array of watersports** is at your command as we visit tiny aquamarine bays and yacht marinas where large ships never call. **Swim** right off the side of the ship; a **snorkel** and mask are the only keys you'll need to unlock the unearthly aquarium-like beauty of the area's many coral reefs. Different **beaches** – each more beautiful than the last – are yours to explore on every island we visit.

Take a scuba resort course, or if you're an experienced diver, explore the famous wreck of the *Rhone*. The less adventuresome can check it out from a glass-bottomed boat. Or learn to **windsurf, parasail** or **day-sail** in these most beautiful Caribbean waters.

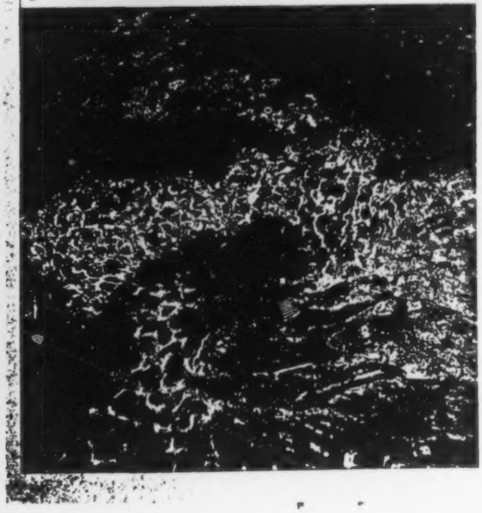
There are opportunities for **golf and tennis** at Fountain Valley on St. Croix and Mahogany Run on St. Thomas, two of the premier sports resorts in the Caribbean. Or if you're a serious angler, you can find adventure aplenty on a **deep-sea charter boat**: blue marlin, wahoo, amberjack and a dozen other species of ocean-going gamesters will be looking for your bait.

Of course, you can just soak up the sun on our spacious teakwood sundecks during the day, or take a stroll at night and share in the local color that's always been the privilege of yachtsmen.

It's up to you. Whether it's rewarding recreational activities you're after, or just the relaxing environment of a luxury yacht designed for 100 people... Clipper respects the individual tastes and lifestyles of its guests.



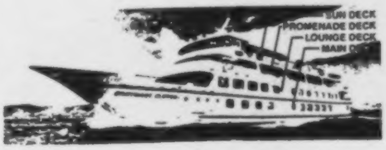
Above: Try your hand at windsurfing; gentle breezes and crystal-clear waters make it inviting... if not easy!

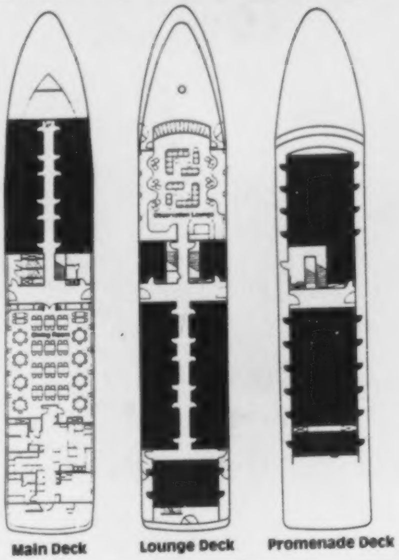


Left, above left: Professional and amateur agree that the waters around the Virgin Islands provide some of the most fascinating snorkeling and scuba diving in the world.

Right: If it's a fight you want, deep-sea fishing might give you the tussle you're looking for. Fish in a striking mood will take the bait of a beginner as readily as that of a veteran.

Clipper's Virgin Islands





Cruise rates per person

Outside double staterooms **$1773**
with two lower beds, private shower
and toilet
MAIN DECK – M11 through M15

Outside double staterooms **$1873**
with two lower beds, private shower
and toilet
LOUNGE DECK – L38 through L41
PROMENADE DECK – P42 through
P49, P51 through P62
Single Occupancy **$2473**

Outside double staterooms **$2023**
with two lower beds, private shower
and toilet
MAIN DECK – M16 through M23
LOUNGE DECK – L26 through L37

Outside double staterooms **$2173**
with two lower beds, private shower
and toilet
LOUNGE DECK – L24, L25
PROMENADE DECK [illegible]0

Third person in stateroom, **$1028**
including children sharing stateroom
with two full-fare paying adults.

Includes round trip airfare between Detroit and St. Thomas, port taxes, and all transfers and baggage handling in St. Thomas.

RESPONSIBILITY Clipper Cruise Line, Inc. and or their agents assume no liability for failure to provide the services and accommodations referred to in this brochure to the extent that such services and accommodations cannot be supplied due to delays or other causes beyond the control of Clipper Cruise Line, Inc. In the absence of negligence on the part of Clipper Cruise Line, Inc., the cruise participant agrees that Clipper Cruise Line, Inc. has no responsibility or liability of any nature whatsoever for damage to or loss of property or injury to or death of persons due to any act, omission or negligence of any carrier, hotel, restaurant, bus carrier, sightseeing company or any other persons rendering any of the services or ground portions of the itinerary and the cruise participant further waives any claim against Clipper Cruise Line, Inc. for any such damage, loss, injury or death. Clipper Cruise Line, Inc. shall not be responsible for any delays, substitution of equipment or any act or omission whatsoever by the suppliers of such services, their agents, servants and employees and the cruise participant hereby waives any claim arising therefrom. Clipper Cruise Line, Inc. reserves the right to decline, accept or retain any cruise participant at any time. **Passage Contract:** The attention of cruise participants is specifically directed to Conditions for Carriage of Passengers as set forth in the passage contract ticket, which should be carefully reviewed before embarkation.

© Clipper Cruise Line 1986

RESERVATION FORM

Newport Clipper Staterooms

Category/Deck	Description	Rate Per Person
My 1st, 2nd and 3rd stateroom choices are:		
1. Main	Outside Double—Two Lower beds, private shower/toilet	$1773 ☐
2. Lounge & Promenade	Outside Double—Two Lower beds, private shower/toilet	$1873 ☐
3. Main & Lounge	Outside Double—Two Lower beds, private shower/toilet	$2023 ☐
4. Lounge & Promenade	Outside Double—Two Lower beds, private shower/toilet	$2173 ☐
Single	Outside Single—Lower bed, private shower/toilet	$2473 ☐
Third person only sharing double stateroom		$1028 ☐

Send to: Grosse Pointe War Memorial Assn.
32 Lake Shore Drive
Grosse Pointe Farms, MI 48236
(313) 881-7511

Enclosed is my deposit check for $__________ ($300 per person of which $100 is non-refundable) I/we understand that if it becomes necessary to cancel the reservation, notification must be submitted in writing and that 30 days or less before departure there will be no refund. Trip cancellation insurance is recommended. Final payment is due Friday, Dec. 5, 1986. Make checks payable to Grosse Pointe War Memorial Association.

Name____________________________________
Last First Initial Roommate

Home Address______________________________

City____________________State________Zip________

Residence Phone________________Office Phone________________

MAKE YOUR RESERVATIONS NOW—SPACE STRICTLY LIMITED

Chairman PICKLE. The Chair is going to ask that panel 5 take their places at the witness table. We are going to have to declare a recess for about 15 minutes due to this vote, but the next panel will consist of Consuelo Lauda Kertz representing Emory University, and William Hutton, professor at Hastings College of Law, University of California. That is panel No. 5, and then we have one more panel after that.

Mr. SCHULZE. The panel will take its seat. We will continue receiving testimony. The chairman is on his way.

If Professor Kertz from Emory University would begin, please.

STATEMENT OF CONSUELO LAUDA KERTZ, ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION, EMORY UNIVERSITY

Ms. KERTZ. My name is Consuelo Kertz and I am an associate professor of business administration at Emory University in Atlanta where I teach taxation courses. I have written some articles on the taxation of industry-sponsored university research contracts, and the staff asked me to appear today.

To summarize my testimony, I think that we all agree that there is controversy about the extent to which exempt organizations compete unfairly with taxpaying businesses in performing research services, including scientific research, laboratory testing, engineering services, and consulting.

The perception of unfair competition exists in part because exempt organizations have become more aggressive in recent years in pursuing industrial sponsorship of their research projects and in part because there is insufficient enforcement of current law.

Everybody that is concerned, the universities and the taxpaying businesses would benefit from more regulatory guidance from the Service about the scope of the exemptions.

I think that the current statutory framework is appropriate and works well to exempt from tax income which is derived from research which is performed in the public interest. There is already a statutory prohibition against private inurement and there is a requirement in the regulations that there be a public benefit from the research which is performed as prerequisites for exemption.

Both these requirements ensure that income from activities which are unrelated to scientific or educational purposes will be taxed. The existing and long-standing interpretations of the Internal Revenue Service properly distinguish between taxable industrial processes, such as testing, which are routine and lack uniqueness and between the exempt activity which is research, which is investigative, intellectual inquiry.

Existing law also taxes income from activity which is arguably research but which benefits only a small group, like a commercial laboratory set up by a single company; and already taxes income from activities which are carried on in excess of what is needed to fulfill an exempt function, such as for the sole purpose of generating revenue.

One problem is that the law in this area is difficult to piece together and more guidance is needed in the form of published rulings and regulations. In addition, the Internal Revenue Service has to be given more resources to enforce the existing law through audits, data collection, and the rulings process.

I think that new regulations and rulings are also needed to reemphasize the public interest requirement and to require that organizations create mechanisms to monitor their own project selection processes and to prevent misuse of university resources for professors' private enterprises.

A particular project should be undertaken by a university only because it furthers an exempt purpose of a university and not because it generates revenue or because somebody is willing to fund it.

At a minimum, this would require an explicit assessment of how a particular project contributes to the performance of exempt functions and would involve assessing conflicts of interest in a project. For example, any researcher who has a direct financial interest in a project would not be the person who makes the final decision to engage in a commercially sponsored project on behalf of the university.

An emphasis on the public interest requirement would help bring the unfair competition issue into perspective because profit-making businesses are not engaging in the scientific activity with that motivation.

Research is currently subsidized with a tax exemption because the results are uncertain and because society benefits through the public interest requirement.

That is the end of my comments.

[The statement of Ms. Kertz follows:]

Statement By
Consuelo Lauda Kertz

HEARINGS BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 25, 1987

Mr. Chairman and Distinguished Members of the Subcommittee:

I am Consuelo Lauda Kertz, and I am an Associate Professor of Business Administration at Emory University, in Atlanta, Georgia, where I teach taxation courses. I have lectured and have written articles on the taxation of universities that engage in commercially sponsored research. 1/ Your Staff requested that I appear before you to give you an overview of this area and to suggest courses of action. I have also reviewed the testimony of many of the witnesses scheduled to appear today.

I. PROBLEM PRESENTED

Some people have charged that the current tax treatment of research activities, including scientific research, analytical and laboratory testing, engineering studies and consulting services creates unfair competition between tax-exempt organizations and private business. Currently, the Internal Revenue Code provides several interconnected bases for tax exemption for "research" or for "scientific" research performed by colleges, universities and scientific research organizations. The charge of unfair competition has arisen at least in part because the scope of the activities which are exempt is somewhat unclear and in part because tax-exempt entities have, in recent years, been more aggressive in seeking support from industrial sponsors to pay for scientific research and equipment.

II. CONCLUSION REACHED

I conclude that the current tax exemptions for scientific research are appropriate, should be retained, and are not unfair to taxpaying entities. However, the existing system can be improved by clarifying the types of activities which constitute exempt research and by enforcing the already existing rules which tax nonqualifying activities. The current rules already tax income from "testing" activities while exempting income from research, but there is misunderstanding about the scope of the exemption. The distinction between taxable and exempt activities can be pieced together from the statutes, regulations, published and private rulings. But everyone would benefit from the Internal Revenue Service drawing all of this information together in one place so that it would be readily available to both taxable and exempt entities. Additional regulations and rulings are also needed to reemphasize the public interest requirement and to require that organizations create mechanisms to monitor their project selection processes. In addition, the IRS must be given the resources to enforce existing law through audits, data collection and the rulings process.

III. CURRENT LAW

Most people agree that it is appropriate for the public to subsidize research and development activity (although there is disagreement about whether tax subsidies or direct subsidies are better and there is some disagreement about the scope of the activities which should be subsidized). Public subsidy is deemed appropriate because the process of invention and research is a risky one and because no single entity can capture all of the returns from its research effort. Competitors, customers, employees, and the public also benefit from innovation and because a single company cannot monopolize all the benefits from its discoveries, the research process must be encouraged. The alternative to existing tax subsidies is the creation of a bureaucracy to determine whether a direct grant should be made to perform particular research. The current system avoids that problem, but creates the problem that not everyone who claims the tax subsidy is entitled to it.

The main bone of contention, and the proper concern of taxpaying providers of scientific services, is that it is often difficult to determine what constitutes scientific research which appropriately qualifies for the tax subsidy. The Code currently exempts from taxation all income from activities which are substantially related to an organization's charitable, educational, and scientific purposes. Code section 512(b) further exempts from the unrelated business income tax income from research carried on by a college, university, or hospital; for federal or state government; or performed by an organization which carries on fundamental research.

One of the problems in this area is that "research" and "scientific" research are not defined in the Code and are only partially discussed in the regulations.(I will tend to use these two terms interchangeably in the balance of my presentation, but the distinction between the two could be made more clear in regulations.) Under the current Treasury regulations, organizations which have a scientific purpose are exempt only if they carry out scientific research in the public interest. Research in the public interest must meet one of several alternative criteria, the most commonly used of which are that the research results are made available to the public through publication, or that the research aids in the education of students or in the treatment of disease. Further, because of the statutory prohibition against private inurement, the research cannot be undertaken solely for the purpose of benefiting a small group, such as a lab set up by a single corporation. The issue raised under current law is what constitutes research which is appropriately subsidized by tax exemption.

Clearly, not every contract to provide services undertaken by a university, hospital, or research laboratory constitutes exempt research; and the nonexempt activities should be subject to tax. At one end of the broad spectrum, existing law properly exempts basic, undirected, nonproduct oriented scientific inquiry. On the other end of the spectrum, the regulations and rulings of the Service make it clear that routine industrial processes such as product testing and materials inspection are not research, and income from such activities is taxable. Current law is also clear that activities which are in themselves arguably exempt, but which are carried on on a larger scale than is necessary for the scientific or educational purposes of the exempt entity are taxed. (For example, income generated by selling excess computer or laboratory capacity or income generated by projects undertaken by an exempt entity solely to offset costs without regard to their scientific merit are currently taxed under existing UBIT rules.)

IV. SOLVING THE PROBLEM

A workable system is already in place, but more resources must be given to the IRS to expand its enforcement role. Existing regulations and revenue rulings could be expanded so that both tax-exempt and tax-paying entities would have more guidance about the gray areas between scientific research and routine industrial processes. Under current rules, the focus is properly on the purpose for which the research is undertaken. Current pronouncements can be expanded to incorporate two recent court cases and, by analogy, to incorporate some of the considerations which went into determining what constitutes research for purposes of the tax credit under Section 41. Additional regulations or revenue rulings which incorporate these recent developments would be helpful in eliminating some of the ambiguous areas which cause the tax-paying entities so much concern.

A. Court Cases

The district court in the Midwest Research Institute_2/ case gave us some guidance in distinguishing scientific research from "routine testing". In that case the Internal Revenue Service asserted that virtually every contract between MRI and industrial sponsors to perform research services generated unrelated business income. Because there was no definition of scientific research in the Code or regulations, the court created one. Scientific research involves experimentation to validate a scientific hypothesis. Routine testing, on the other hand, while it might require sophisticated scientific knowledge or equipment, has measurement of specifications as its purpose. The United States Claims Court in the IIT Research Institute _3/case was faced with a similar challenge by the IRS of industrially sponsored research contracts. The Claims Court focused on the problem-solving nature of scientific research in order to generate a workable definition of research.

Importantly, in both these cases the courts examined the entities' motivation for undertaking the research, and were influenced by the fact that the organizations selected their research projects based on appraisals of their scientific interest rather than on their financial return. The organizations also ceased to work on projects once the scientific principles were established and left routine quality control testing and commercial development to taxable businesses.

B. Section 41 Analogy

The Congress has recently faced an analogous problem in renewing and changing the tax credit under Code section 41 for increasing research expenditures. The concern was that the credit was being taken for virtually any type of product development, including financial services and for products which were not necessarily innovative. After much debate, the credit was modified so that it is only available for two types of research activity. The credit is available for part of a company's expenditures for support of basic university scientific research, which is generally taken to mean research which has no particular commercial applicability. This type of research creates no UBIT problem. The credit is also available for research undertaken to discover information which is technological in nature, is aimed at the development of a new business component of the taxpayer, and the activities of which are part of a process of experimentation. While it is inappropriate to impose the trade or business requirement on a university and require that it develop a business component for itself, the interesting and helpful concept which emerges is that the activity which qualifies for the credit is not routine, but is instead innovative activity in which the end result is not certain because of the experimentation aspect.

C. Analysis

The common thread that emerges from the cases and the section 41 analogy is that routine industrial processes such as materials testing are not research that qualifies for exemption. This is the test which exists under current law. Only processes of inquiry where results are uncertain, and which are done in the public interest, such as experimentation aimed at discovering new information, are research. Further, even "research" which is undertaken solely to defray costs or to keep the lab running is not exempt.

Research which should be subsidized by a tax exemption, as opposed to testing, has at its core the lack of certainty about the results, which are often formulated by an experimentation process. Because of uncertainty and because any new information or processes which are developed become part of the knowledge base of the rest of society (through the public interest requirement), this seems an appropriate place for tax exemption. A for profit entity is unlikely to engage in research service projects with a public interest motivation.

V. RECOMMENDATIONS

It is important to inquire about the purpose of the research activity and to ask how that activity furthers the exempt purposes for which an organization is chartered. Institutions could use more guidance and should be urged to create internal review procedures to assure that research designs and protocols are undertaken because of scientific interest rather than the availability of funding. For example, in any self-governing review of whether to undertake a contract, researchers with a direct stake in a particular project would not have final the decision-making authority. It is hard to expect the researcher who wants his lab to continue to operate to be entirely objective about which projects are undertaken. Similarly, all financial dealings between the researcher and the funding entity should be disclosed to try to avoid conflicts of interest.

In a university, for example, it is clear that all the constituencies of the university, and not just the scientists and budget officers, have a stake in the type of research that is conducted. Resources which are diverted to funding big science and high technology and its expensive equipment and laboratories are not being spent on other, less commercially attractive areas of the university. We should all have some concern about assuring the traditional independent role of the universities in fostering all types of intellectual inquiry is preserved. Many thoughtful articles have been written about the impact of commercial funding on the tenure process and academic freedom in general._4/ The concerns that scholars raise are important ones.

In addition, the cost of providing sophisticated equipment [illegible] reach of most universities without "partners", either governmental or industrial. More guidance is needed from the Service about the types of relationships, including joint ventures, joint ownership of facilities, and partnerships which can appropriately be used by exempt entities. Any appropriate relationship would assure that the entity is operated exclusively in the public interest. At the same time, the exempt entities should be encouraged to adopt procedural safeguards to protect the integrity of their decision-making processes so that the availability of commercial support or governmental interest in an area are not the sole measures of their importance to the university.

ENDNOTES

1. Kertz, C.L. and Hasson, J.K., "University Research and Development Activities: The Federal income Tax Consequences of Research Contracts, Research Subsidiaries and Joint Ventures." 13 J. Coll & Univ. Law 109 (Fall 1986). Kertz, C.L. ,"Tax Exempt Organizations and Commercially Sponsored Scientific Research", 9 J. Coll & Univ. Law 69 (1982-83).

2. Midwest Research Institute v. United States, 554 F.Supp. 1379, aff'd, 744 F.2d 635 (8th Cir. 1985).

3. IIT Research Institute v. United States, 85-2 USTC par. 9734 (Ct.Claims 1985).

4. For example The National Education Association Higher Education Journal devoted its inaugural edition to these issues. See "Research and the Academy", Vol. 1 Thought and Action, Fall 1984. See also, Goggin,M. ed., Governing Science and Technology in a Democracy, (Univ. Tennessee Press 1986).

Mr. SCHULZE. Thank you. Mr. Hutton.

STATEMENT OF WILLIAM T. HUTTON, PROFESSOR, HASTINGS COLLEGE OF THE LAW, UNIVERSITY OF CALIFORNIA

Mr. HUTTON. My name is Bill Hutton. Although I am a professor at Hastings College, University of California, I do not appear as a representative of the university nor of one of the several exempt organizations I represent, but rather—as with Ms. Kertz—at the invitation of the staff.

I would like to make a few remarks from testimony that will be submitted within a week to the committee in written form. It surprises me, in listening to the testimony throughout this morning and early afternoon, that no representative of any exempt organization has raised the point that there is a hard edge to the privilege of tax exemption, a downside to the recognition of tax-exempt status.

It is not good, that is exemption from income tax, in every circumstance. Let me illustrate that with a situation that I think is probably fairly typical of colleges and universities. Let us assume we have a business which we acknowledge is unrelated and which pays tax at corporate rates.

Let us also assume, as I suspect is true in the vast majority of cases, that the core purposes of the university or the college produce losses. I think that you will acknowledge, those of you who receive solicitations for alumni contributions, that that is a fairly standard state of affairs.

In a tax-exempt world, then, this enterprise which, on a consolidated basis is producing losses, is subject to tax. I offer that not in terms of any suggestion, legislative or otherwise, but simply to put things in perspective. There are no, in my view, immaculate, elegant solutions to what is a very difficult line-drawing problem. I have thought about this problem at some length.

One elegant solution which has been suggested by respectable academics is to abolish the unrelated business income tax entirely. In light of the relatively minimal amount of income it raises, that suggestion is certainly not insensible; $53 million was apparently the tax raised by the unrelated business income tax provisions in 1986.

But as a symbolic matter, as this hearing would indicate, that course of action is almost unthinkable. The world is not ready for that.

At the other end of the conceptual spectrum would be, the suggestion I just made, to afford tax exempt institutions the privilege of the renunciation of their tax-exempt status and to report on a consolidated basis. This would have the effect of eliminating the tax for lots of institutions that presently file the form 990-T and pay some tax at corporate rates.

It seems to me the world is not ready for that one either. So where does that leave us? I think it leaves us with a fairly sensible approach—the approach taken by the Treasury—that the basic concept is solid but that we need to look rather hard with new data at the perimeters of the rule and the way it is applied and the way exempt organizations report.

From my own experience, let me just offer a couple of observations on that score. When an organization applies for exempt status on form 1023, it recites its intended activities and its intended sources of support. Typically, those sources of support do not include any mention of unrelated business income. It would be very unusual, in my experience, for an organization to represent that it was going to be engaged in an unrelated trade or business at the outset. And in fact, it might defeat their chances for recognition of exempt status, since any substantial nonexempt purpose will disqualify an organization for exemption under whatever provision it seeks to be recognized under. So it does not acknowledge any unrelated business intent at that point.

Now let us go down the road a year or two. The organization now has the opportunity to engage in a revenue-producing activity, an activity which arguably is sufficiently related. If the argument is reasonable, albeit a debatable issue, it will probably not file a form 990–T. It may have income, net income, from that activity but it is very unlikely to be revealed on the form 990 that they file on a regular basis.

The form 990 reports of revenues are aggregated. They may show up only under the line that says "program service" revenues. And the IRS, in my experience, is not equipped effectively to audit that particular question. Even if they file the 990–T, the 990–T may not reveal the existence of other enterprises which the organization believes are sufficiently related.

So any sensible administrative system ought to start, at least at a minimum, with a question on the form 990 that asks: Have you begun to engage in any revenue-generating activities during the current taxable period, yes or no? It should probably be broader than that, but at least that would be a start.

A suggestion was made by a member of the committee earlier today that exempt organizations ought to be able to generate financial information as to each separate revenue-generating activity they engage in. I think that is sensible and I think that might very well be required as a backup to the kinds of questions that I am suggesting.

To focus on the relatedness test itself, for one brief moment before I close these remarks, it seems to me that as interpreted by the IRS, the regulations are flawed. Until 1967, we had a test which required the putative related activity to have as a principal purpose the advancement of the proper exempt purposes of the organization.

In 1967, that test was changed. It was watered down and the regulations now require only that the activity "contribute importantly to." The way the IRS has viewed that "contribute importantly to" standard, we have for example the sanctioning of—as related activities—the sale of T-shirts with composers' or artists' likenesses on them, ashtrays, panda bears by environmental organizations that have some recitation of the environmental dangers to the species and so forth. Almost, I would say, to the point of absurdity.

I would recommend a couple of things in regard to the relatedness test. First that either there must be some demonstrable functional relationship to an activity already carried on and recognized as a basis for exempt status. That would, for example, subsume the convenience exception, as to dormitories, cafeterias, et cetera.

Or if that is not the case and no functional relationship can be shown, then the new activity should be judged on a stand-alone basis. In other words, if this were the only activity to be carried on by the exempt organization, would the organization be entitled to tax exemption on the basis of that enterprise?

I think those approaches would put some teeth into the rule of the statute, which I do not think needs changing, and the approach of the regulations, which I believe need amendment.

Thank you.

Mr. SCHULZE. Thank you. You both have been very succinct and very helpful.

Professor Kertz, in your testimony you mentioned two recent court decisions, the ITT Research Foundation and Midwest Research Foundation, which addressed the question of whether scientific research is subject to the UBIT.

In both cases, the court gave guidance on what constitutes scientific research. Did the decisions in these cases clarify questions on what constitutes scientific research or is there still a lot of uncertainty in this area?

Ms. KERTZ. I think the cases went a long way to helping us understand what scientific research is because the regulations are not particularly helpful. There are also very few published rulings in this area.

As I said, you have to piece together what is exempt research activity and what is not. The cases are helpful because they add the idea of that research involves an experimentation process. The fact that the results are uncertain, and that there is something unique about the activity which is going, that it is not some sort of industrial process which is done solely for certification let us say of drugs, or that sort of thing are part of what makes an activity research. They are quite helpful in that way.

That is not to say we could not use somebody bringing all this together, and it seems to me the Treasury or the Internal Revenue Service through the rulings process is the organization to do it because the law is clear enough about what is exempt and what is not. There is this relatedness test.

But I think that what happens in the real world is that universities see opportunities to generate income, to keep their labs running, to keep the piece of expensive equipment going, and the researcher simply takes the money from industry or government and runs with it, which is understandable. But I think what we need is more introspection on the part of the universities about why they undertake projects.

I think we need some guidance from the Service which will encourage them to be introspective about the nature of their activity.

Mr. SCHULZE. You alluded to this. In your opinion, have the courts given sufficient guidance to the scope of research activity exemption or have they been definitive enough, or do we need more?

Ms. KERTZ. I think that the rules are definitive enough. It is just that not everybody is aware of what the rules are. I think big research universities have very sophisticated counsel and have good advice. But that is not where the problem areas are.

I read the testimony of the independent laboratories that compete with hospital laboratories, for example. I am not sure that everybody has access to the kind of information they need to separate related from unrelated.

Mr. SCHULZE. Did you agree with the court's decisions in those two cases?

Ms. KERTZ. Yes, in general, I did.

Mr. SCHULZE. Should we try to change the allocation rules applicable to joint ventures between tax and tax-exempt, as Treasury proposes?

Ms. KERTZ. I have not read the entire Treasury proposal, but I understand it has proposed to change the control requirement. I have not read them completely, but I think it needs to be looked at, particularly when the joint venture subsidiary route, the taxable subsidiary routes are used pretty much as subterfuges.

Mr. SCHULZE. If you can give us any guidance on how we determine that, we would appreciate it. That is another gray area that we run into.

Thank you, Professor.

Professor Hutton, in your opinion and from your point of view, are universities getting more and more into commercial type activities?

Mr. HUTTON. I think there has been a temptation over the last——

Mr. SCHULZE. Are the trends in that direction?

Mr. HUTTON. Certainly, particularly for organizations which have historically depended heavily on large contributions. Since 1981, we have seen an enormous diminution of the charitible contribution incentive, which I happen to believe is an effective incentive, particularly as to contributions of appreciated property.

The 1986 act contained what, in my view, for some organizations a devastating provision in the alternative minimum tax that subjects capital gain property to a reduction, in effect, a reduction for charitable contribution purposes.

Those developments necessarily drive not merely colleges and universities, but lots of different kinds of organizations to seek alternative sources of revenue.

Mr. SCHULZE. One of my pet peeves is I think that universities should derive much of their income and spend a lot of their time shaking the alumni tree. There should be some kind of an obligation of those who have graduated and have been somewhat subsidized in the past to contribute. Perhaps universities and colleges do not play enough on that guilt angle to get enough money.

It seems to me that they are not doing a sufficient job in that area. But in your opinion, are universities shifting from that area and other fundraising areas into more unrelated or passive investments?

Mr. HUTTON. No, I do not think there is a shift away from the so-called development activities, a euphemism for fundraising, but I think there is a fear that unless the traditional development approach is amplified by lots of interesting devices in recent years, life income trusts and so forth, those traditional sources are not going to be adequate to meet their financial needs.

They will not turn their backs on the profit potential merely because it involves exploring new areas. What it comes right down to, though, if a college or university is confronted with a proposition which looks like it will be economically successful but which may result in the payment of some unrelated business income tax, they are going to say all right at worst we will pay some unrelated business income tax.

Mr. Schulze. Some of the colleges earlier testified that this was a part of their normal decisionmaking process. Is that your opinion, that most of them do that, or would they be an exception?

Mr. Hutton. I could only give you an offhand and anecdotal response, but it certainly would not surprise me if that is the case.

Mr. Schulze. Have you looked over Treasury's proposal?

Mr. Hutton. I have. In fact, I had not seen it until this morning, but I have had ample time today to read through it.

Mr. Schulze. I would like to just get your opinion, off the top of your head, of broadening the definition of controlled subsidiaries because of increasing use of subsidiaries by exempt organizations.

Mr. Hutton. This has been a statutory anomaly since it was enacted in 1969. You are talking about point four on the summary of Treasury proposals. That legislation, as many of us remember, was enacted in some haste and with insufficient attention to technical details.

So the definition of "control" of a subsidiary, which sets the statute into operation and causes what would otherwise be passive income, rents, annuities, royalties and so forth, not to be taxed to the parent organization, is simply imported from the corporate tax provisions and is very easy to avoid. It is very easy to have a "decontrolled", but nonetheless effectively controlled subsidiary corporation.

So I think the Treasury's suggestion is entirely salutary.

Mr. Schulze. How about their proposal on making applied, purely commercial activities, subject to UBIT?

Mr. Hutton. This is point 3? I am not sure I am with you as to the suggestion.

Mr. Schulze. I think they were changing the definition of applied research or purely commercial activities.

Mr. Hutton. I think that is, if I understand the suggestion, I think that is a fairly tentative point 6 suggestion. We believe additional attention should be given to the definition of research. I believe that myself. I do not have intensive experience with the research area, but I do think that the notion of public benefit and the immediacy of public benefit needs to be further defined.

Mr. Schulze. How about limiting the "convenience of students" exemption?

Mr. Hutton. I would eliminate that. It seems to me that the Treasury approach, which says that those activities would normally be considered related anyway, makes that rule unnecessary. I can think of few examples outside those traditional ones of dormitories and cafeterias, et cetera, which qualify under the convenience exception.

It seems to me those pretty clearly ought to be considered related activities.

Mr. SCHULZE. I think your suggestion for the additional line on the tax return is very good, one of the best that we have received, because that would certainly open up the next series of questions. We appreciate that.

Thank you both for your testimony.

Chairman PICKLE. Professor Kertz, before you leave, do you agree with the Treasury's recommendations?

Ms. KERTZ. I only just read them this morning and I have not read the follow up material in them, but in general they are very sensible kind of proposals.

Chairman PICKLE. We would ask you to give us a letter stating your general feelings on the recommendations made or any other suggestions.

Thank you both very much.

Our sixth panel is Dr. Alton Hopkins, John Hoyt, Nolan Rubin, David Wills, and Robert Cummings.

You might just take any seat, but you might start over here, Hopkins then Mr. Hoyt, then Mr. Rubin and Mr. Wills and then Mr. Cummings.

I thank you gentlemen for waiting. It has been a long day, a lot of folks, and we are not through yet, but I thank you for your patience and your understanding.

We will ask the first witness, Mr. Cummings, if you will proceed.

STATEMENT OF ROBERT S. CUMMINGS, ESQ., SECRETARY, BOARD OF DIRECTORS, MASSACHUSETTS SOCIETY FOR THE PREVENTION OF CRUELTY TO ANIMALS

Mr. CUMMINGS. Thank you, Mr. Chairman.

My name is Robert Cummings. I am secretary and counsel to the Massachusetts Society for the Prevention of Cruelty to Animals. I have previously submitted testimony and I will try to summarize what I think are the more pertinent points in that testimony.

The MSPCA, which is one of the oldest humane organizations in the United States, operates three veterinary hospitals, the largest of which is operated in Boston and is called Angell Memorial Animal Hospital. That hospital has been in operation since 1915 and we believe it to be one of the largest full service animal hospitals in the United States.

It operates a full service animal hospital in the sense that many human teaching hospitals operate with the various departments and specialties which are common to medical treatment of humans and, in the case of Angell, of animals.

The operation of Angell and the other hospitals which are operated by my society are closely intertwined with the humane activities of our organizations. The veterinarians in the hospital provide medical treatment to our shelter animals. They participate in our humane education programs and they cooperate with our law enforcement department.

I would like to stress this afternoon some of the services which are provided by our hospital department which we think are unique to a humane organization and are not generally available to the public from private veterinary clinics or private veterinary practitioners.

We provide a training function in which we train veterinary nurses, paramedics, and we provide internship and residency programs for veterinarians in the many areas of specialty which are practiced within our hospital. Our hospitals are constantly improving the treatment and the procedures used in animal care in the same way that a human hospital is constantly perfecting the methods of treatment of persons coming under their care.

We have specialties within our hospital which are not generally available in smaller clinics and from private practitioners. They include ophthalmology, radiology, pathology, oncology, sophisticated surgical procedures, gastroenterology, intensive care, cardiology, orthopedics. We treat exotic animals, such as rare birds and zoo animals.

We provide significant free care in the course of each year to persons who are unable to pay for the care of their animals. We promote and participate in spay/neuter programs in order to deal with the surplus animal problem which, as my testimony indicates, is one of the leading humane problems in the United States today.

We provide treatment for the animals which are brought to our shelters. The veterinarians in our hospital are commissioned law enforcement agents, several of them are, and with our law enforcement department, they participate in the prosecution of cruelty complaints, in the investigations of slaughterhouses, inspections of pet shops, research facilities and other facilities which the society has the statutory power and authority to inspect and to engage in law enforcement activities to ensure that the regulations of our state are complied with.

Our veterinarians participate in disaster relief projects, such as the rescue of sea birds which are damaged by oil slicks, and other disaster programs, often working with affiliated international and other national organizations. Our veterinarians participate in publicity programs, such as radio programs and other animal health programs.

The cost of providing these programs is substantial. We have enjoyed no low cost or low income free financing. Our wages are at least comparable to those of the industry. Our hospital workers are unionized so that we are paying current market wages.

Should our activities be taxed, it would result in a cutback of our activities. And at present we have no, as an organization neither in our hospitals nor as a humane organization, we have no unrelated business income and we have paid accordingly no unrelated business income taxes.

I would be happy to attempt to answer any questions, and I thank you, Mr. Chairman, for this opportunity.

[The statement of Mr. Cummings follows:]

Respectfully Submitted by

Robert S. Cummings, Esquire
Massachusetts Society for the Prevention
of Cruelty to Animals

Mr. Chairman, members of the Committee, my name is Robert Cummings and I am the Secretary of the Board of Directors of the Massachusetts Society for the Prevention of Cruelty to Animals (MSPCA) and serve as the MSPCA's legal counsel. I am here today to speak on behalf of the MSPCA regarding full service veterinary clinics which are owned and operated by humane societies.

One of the questions being addressed today is whether monies generated by full-service veterinary clinics run by not-for-profit humane organizations represent unrelated business income. It is the MSPCA's belief that the answer to that question is "no". To the contrary, the operation of the full-service veterinary hospital is central to the mission of a humane organization--preventing cruelty to and relieving the suffering of animals. To illustrate this belief I would like to comment on the role of hospitals within the MSPCA.

The Massachusetts SPCA is the largest and most comprehensive humane society in the United States. Established in 1868 by George Thorndike Angell, the MSPCA today employs over 400 individuals. We operate eight animal shelters across the state of Massachusetts; employ 12 law enforcement agents who are responsible for enforcing the state's anti-cruelty statutes as well as for inspecting numerous facilities which house or keep animals, such as riding stables, pet shops, zoos, animal dealers, research facilities, etc.; carry out humane education programs which reach over 30,000 school children annually; publish brochures, magazines and literature on pet care and animal related issues; and operate full service animal hospitals which treat and care for over 74,000 animals each year. Each of the services of the MSPCA is vital to the overall mission of the organization--the very reason that the organization was formed 119 years ago -- to relieve suffering, prevent cruelty and develop a just and compassionate society. It is through the MSPCA's hospitals that the depth of our work is most evident.

The Massachusetts SPCA currently owns and operates three veterinary hospitals. They are the Nantucket Animal Clinic and Hospital in Nantucket, Rowley Memorial Animal Hospital in Springfield and, the oldest and largest of the three, Angell Memorial Animal Hospital in Boston, which is dedicated to the MSPCA's founder, George Angell. The MSPCA's Angell Memorial Animal Hospital was founded in 1915 to give sick and injured animals "the best care that modern knowledge can provide," according to Dr. Francis H. Rowley, the MSPCA's second president and founder of the first MSPCA hospital.

Angell Memorial Animal Hospital is recognized throughout the world as a leader in veterinary medicine. It is the largest and most comprehensive animal hospital owned and operated by a humane society in the world. The physical plant consists of nine (9) examination rooms, six general wards which contain 32 cages, 4 runs and 4 exercise runs in each ward, two isolation wards, one exotic/small mammal ward, a radiology ward with three x-ray rooms, eight fully equipped surgical suites, recovery and prep rooms, pathology department, a pharmacy and our recently completed Intensive Care Unit which includes fifty-six cages and six runs and is a twenty-four hour critical care facility.

During its seventy-two years of operation, Angell Memorial Animal Hospital has provided training for 280 veterinary school graduates wishing to advance their knowledge and skills in veterinary medicine. Graduates of Tufts, Texas A & M, Georgia, Tennessee, Cornell, and many other veterinary schools across the nation have served a fourteen-month internship at our hospitals in Boston and Springfield. They come to the MSPCA to train under highly experienced specialists - including specialists in the fields of oncology, cardiology, opthalmology, orthopedics, and surgery among others - and to handle cases that are more varied and difficult than they would receive in most private practices.

The veterinary staff at the MSPCA's three hospitals are an integral part of the overall programming of the organization. Their work directly supports every department's programs. For instance, through our law enforcement division, the veterinary staff assists in the inspection of research facilities and pet shops to check for compliance with state laws and regulations. As agents of the State Department of Public Health and the Department of Food and Agriculture, Division of Animal Health, the MSPCA is responsible for inspecting state licensed research facilities which use dogs and cats and all pet shops for compliance with state regulations pertaining to animal health, sanitary conditions, euthanasia practices and proper housing and quarantine standards. The expertise of our veterinary staff is essential in evaluating compliance of these institutions with existing regulations and in recommending changes of procedures based on advances in scientific knowledge. The MSPCA's veterinarians have also been called as expert witnesses to testify in various criminal cases as to the treatment, or lack thereof, of animals whose owners have been charged with violation of state cruelty laws.

Often, the decision of the court as to the validity of the charges hinges upon the testimony given by a veterinarian. By having in-house expertise on animal health and husbandry, the MSPCA is better able to fulfill its role as law enforcement agents--a role that, for the most part, is seldom undertaken by traditional state law enforcement agencies and is left to the non-profit humane societies.

Over 50,000 animals are surrendered to our shelters each year. Although some of the animals surrendered to us are perfectly healthy animals, capable of being placed in responsible new homes immediately, many others are in need of veterinary care prior to being offered for adoption. Each animal needs a careful screening and evaluation to determine its capability of being placed in an adoption ward. Often, the procedures required to rehabilitate an animal are more complicated or technical than those that can be performed by a lay person. Various state laws also prohibit lay individuals from performing some procedures and therefore require the services of a licensed veterinarian. MSPCA veterinarians perform a vital service in evaluating and treating shelter animals.

A major part of any humane society's task in preventing cruelty to animals is combatting the massive pet overpopulation problem. A three-prong approach is necessary to curb the indiscriminate breeding of animals and to halt the enormous destruction of healthy but unwanted animals. First, comprehensive animal control ordinances must be enacted and enforced by local animal control authorities. Second, a public education program which stresses responsible pet ownership and emphasizes the cruelty and waste of pet overpopulation must be conducted throughout the community. And third, low cost sterilization programs available to all pet owners, regardless of their ability to pay, must be offered. The humane society plays an important role in providing low cost spay/neuter programs. Contributors who believe in curbing the pet overpopulation problem are willing to underwrite these programs by making donations to subsidized sterilization programs. The MSPCA is no exception to this program. Each of our hospitals performs hundreds of spay or neuter operations. To make these surgeries affordable and thereby increase the incentive to the pet owner to have the surgery performed, the MSPCA subsidizes the cost of the operations to lower the fees charged to the public.

The MSPCA, through its hospitals, is able to provide comprehensive referral services to the private practitioner in areas where his or her resources may be limited. These services may include critical care, specialized diagnostic procedures and sophisticated surgical techniques. Referrals to our hospitals come from veterinarians in all areas of New England, as well as from states hundreds of miles away.

The Nantucket Animal Clinic and Hospital is the only veterinary facility on that island. This facility has integrated itself into the island community to serve as a complete resource center for animal health needs. The veterinary staff conducts clinics throughout the year at low cost or no cost to island pet owners to check animals for feline leukemia, geriatric problems, parasites, Lyme disease and heartworm. This hospital also provides senior citizens discounts throughout the year to elderly pet owners. The clinic also provides a low cost spay/neuter program. Humane education programs are routinely carried out in the island's school by the veterinary staff to educate school children about proper pet care. These many services are not provided by any other group or individual on the island.

The development of new treatments or surgical procedures is not uncommon at Angell Memorial Animal Hospital. The veterinary staff at Angell was responsible for the development of the diaphramatic hernia repair and the Schroeder-Thomas splint. The discovery of the dangerous side effects of medroxyprogesterone, a canine birth control drug, and of the horizontal transmission of feline leukemia virus and the relationship of this virus to the occurrence of other cat diseases were made by MSPCA staff veterinarians. These discoveries and advancements were possible in large part due to the vast and diverse clientele served by our hospitals. The knowledge acquired by our staff veterinarians is shared with veterinarians in the private sector through lectures at local, state, national and international veterinary conferences and scientific journals, thereby assisting animals throughout the country and the world and increasing the scope of the MSPCA's efforts to relieve the suffering of animals.

Originally established as hospitals for the working horses of the early 1900's, the MSPCA's hospitals have changed over the years to serve the changing trends in animal ownership and will continue to do so in the future, serving pet owners from all walks of life. The rich, the poor, the young, the old, the educated, the illiterate--all bring their animals to MSPCA hospitals for care and treatment. By establishing an open door policy, the hospitals put the needs of animals first and treat each animal according to what will be in the best interest of that animal.

In conclusion, I would like to state that the charitable full-service veterinary hospital serves a crucial role in the community's response to animal welfare concerns. By restricting the not-for-profit humane organization's ability to fill this role, Congress would create a void which would not easily or readily be filled by the private sector. It is certain that in the present climate of concern over federal budget deficits, the government would not step in to fill this void. Therefore, I would urge the members of this committee not to restrict the ability of humane societies to own and operate full-service veterinary hospitals which serve the needs of all animals within the community and carry out their mission in preventing cruelty and relieving suffering.

Thank you for allowing me this opportunity to speak to you about this important issue.

Chairman **Pickle**. We thank you. We will proceed with the testimony. And I am going to start now with Dr. Hopkins and go right down the list. Dr. Hopkins.

STATEMENT OF ALTON F. HOPKINS, D.V.M., PRESIDENT, AMERICAN VETERINARY MEDICAL ASSOCIATION, ACCOMPANIED BY HAROLD KNIRK, D.V.M.

Dr. **Hopkins**. Thank you, Mr. Chairman. I do appreciate your extending me the opportunity to speak on behalf of the 46,000 veterinarians who are members of the American Veterinary Medical Association. The AVMA represents 85 percent of the veterinarians in this country, which makes it unique among professional organizations.

My name is Al Hopkins. I am a private practitioner from Dallas, Tex. I am currently president of the American Veterinary Medical Association.

Today I would like to share the veterinary medical profession's perspective on the unrelated business income tax and the pinch that private practice veterinarians are feeling from unfair competition by some tax-exempt humane organizations.

The organizations of which I speak have expanded their original purpose from preventing cruelty to animals into providing veterinary services for a fee to the general public. These clinics built by tax-exempt contributions compete directly with the private sector, and as a result private veterinary practices are suffering.

The trend—and I think that is a key word because it has appeared so many times in today's testimony—the trend toward operating full service veterinary facilities as a means to generate revenues for tax-exempt organizations threatens to undermine the integrity of tax-exempt organizations engaged in legitimate charitable activities.

Veterinarians value the contributions of teaching institutions which provide research, internships, residencies and other learning opportunities, and recognize that educational institutions such as colleges of veterinary medicine must offer clinical services to the public in order to provide clinical education for veterinary medical students. Providers of these services, as well as those operated for the benefit of stray animals or animals owned by indigents should continue to operate their facilities with the full benefits of their tax-exempt status. They have our full support.

I want to make it perfectly clear that we do not object to the operation of veterinary clinics by tax-exempt organizations, provided these clinics are operated under the same laws that govern private enterprise. Nonprofit corporations enjoy tremendous tax and promotional advantages, as well as access to low cost capital for construction and equipment.

And so with the exceptions noted earlier, we propose that any medical practice offering a full range of services for a fee to the general public be required to operate as a separate tax paying entity from its tax-exempt parent. In short, we do not object to legitimate competition. However, we cannot survive when the competitors are playing under different rules.

Veterinarians support most of the goals of humane organizations and welcome opportunities to work together with them. Local veterinarians typically serve on the boards of directors of their local humane societies. Cooperative ventures between humane organizations and private veterinary practitioners abound.

In Texas, in Austin Travis County, the humane society maintains an exemplary program and excellent relationships with the local veterinary professionals. And in my home city of Dallas, the local veterinary association and the SPCA have a long history of working together to benefit the community.

But the AVMA is concerned that some government subsidized veterinary services are being instituted for the wrong reasons: to increase the sponsor's income or perhaps to enhance the sponsor's public image. Whatever the reason, the emergence of full service clinics across our land has generated a great amount of tension between private veterinary practitioners and the tax-exempt organizations. The issue here is not animal welfare. The issue is simply fair competition.

Sixty percent of the veterinarians responding to a recent survey by the General Accounting Office reported perceived competition with at least one nonprofit humane organization. This same study also revealed an overwhelming perception among our private practitioners that this unfair competition is increasing. Our national office has been contacted by veterinarians from California, Florida, Illinois, Maryland, Michigan, New Jersey, New York, Pennsylvania, Texas, Virginia, and Utah who are concerned about competition that they face from tax-exempt organizations.

AVMA does not advocate imposing an unreasonable burden on the tax-exempt community. We advocate fairness. We believe, at the very least, the definition of unrelated business income should be clarified. And more importantly, the unrelated business income tax should be enforced.

AVMA recognizes that so far only a minority of tax-exempt organizations abuses its tax privilege. However, there must be recourse to bring these abusers into compliance. I submit that the U.S. Congress has the obligation to do what it can to level the playing field. Adequate enforcement of the unrelated business income tax is a necessary first step.

Thank you again for the opportunity to testify, Mr. Chairman.

[The statement of Dr. Hopkins follows:]

Statement on Behalf of the
American Veterinary Medical Association

presented by

Dr. Alton F. Hopkins, President

June 25, 1987

Mr. Chairman and members of the Committee, thank you for granting me the opportunity to speak on behalf of the more than 45,900 members of the American Veterinary Medical Association. I am Dr. Al Hopkins, President of the AVMA. With me are Dr. Harold Knirk of Lansing, Michigan, and Ms. Marcia Brody of the AVMA's Governmental Relations Division. Dr. Knirk has had extensive experience with this issue in Michigan. Following my comments, we will be happy to answer any questions you may have.

Today I would like to share veterinary medicine's perspective on the unrelated business income tax, and the impact that private practice veterinarians are feeling from unfair competition by tax-exempt organizations.

Private veterinary medical clinics around the country have been forced into unfair competition with nonprofit organizations that operate full service veterinary hospitals. The tendency of nonprofit organizations to operate full service veterinary facilities as a means to generate revenues for their organizations threatens to undermine the integrity of tax-exempt organizations engaged in legitimate charitable activities such as teaching veterinary medicine or providing veterinary medical care for stray animals or for animals owned by people unable to pay for necessary veterinary services. Today I am talking about tax-exempt organizations that provide full veterinary medical services for a fee to the general public. These clinics, built by tax-exempt contributions, compete directly with private practitioners. As a result, private sector veterinary services are stifled.

We do not object to the operation of veterinary clinics by tax-exempt organizations, provided that these clinics are operated under the same laws that govern private enterprise. Nonprofit organizations enjoy tremendous tax and promotional advantages as well as frequent access to low-cost capital for construction and equipment. Many gain a competitive edge due to lower labor costs. We propose that any veterinary medical business, offering a full range of services for a fee to the general public, be required to operate as a separate tax-paying entity from its tax-exempt parent, with few exceptions. We do not object to legitimate competition; however, we cannot survive when the competitors are playing under different rules.

Veterinarians are strongly supportive of the goals of humane organizations and welcome opportunities to work together with them. Local veterinarians typically serve on the boards of directors of humane societies across the country. Cooperative ventures between humane organizations and private veterinary practitioners abound. In the State of New Jersey, for example, almost two-thirds of all veterinary practices participate in a publicly-subsidized spay or neutering program.

AVMA appreciates the contributions that various organizations have made and continue to make in the field of animal welfare. We encourage our members to become involved in the activities of animal control groups and humane organizations. We value the contributions of teaching instutions that provide research, residencies and other learning opportunities and recognize that educational institutions such as colleges of veterinary medicine must offer clinical services to the public in order to provide clinical education for veterinary medical students. Providers of these services, as well as those operated for the benefit of stray animals or animals owned by indigents, should retain their tax-exempt status.

AVMA is concerned that government-subsidized veterinary services may be instituted for the wrong reasons, perhaps to increase the sponsor's income or to enhance the sponsor's public image. The emergence of full-service clinics in many states has generated tension between private veterinary practitioners and tax-exempt organizations. The issue here is not animal welfare. The issue is simply fair competition.

More than 60 percent of the veterinarians responding to a recent survey by the General Accounting Office reported perceived competition with at least one nonprofit organization. This same study also revealed an overwhelming perception among private practitioners that this unfair competition is increasing.

AVMA does not advocate imposition of an unreasonable burden on the tax-exempt community. We advocate fairness. We believe that at the very least, the definition of unrelated business income should be clarified and more importantly, the unrelated business income tax should be enforced. AVMA recognizes that a minority of tax-exempt organizations abuses the law; however, there must be recourse to bring those abusers into compliance. The United States Congress has the obligation to do what it can to level the playing field. Adequate enforcement of the unrelated business income tax is a necessary first step.

Thank you. We will be happy to respond to any questions you may have.

Chairman **Pickle**. Thank you, Dr. Hopkins. And now, Mr. Hoyt, would you proceed?

STATEMENT OF JOHN A. HOYT, PRESIDENT, HUMANE SOCIETY OF THE UNITED STATES

Mr. **Hoyt**. Thank you very much, Mr. Chairman. My name is John Hoyt. I am president of the Humane Society of the United States. I am also president of the World Society for the Protection of Animals, a consortium of 360 organizations representing 64 different countries.

I have, Mr. Chairman, submitted written testimony and I would request that these comments today also be included in the record.

Chairman **Pickle**. Without objection.

Mr. **Hoyt**. I am speaking here today on behalf of the 600,000 Americans who are constituents of the Humane Society of the United States, as well as several millions of people who are members of hundreds of local humane societies and SPCAs across America.

The fundamental purpose and mission of the approximately 2,000 animal protection societies throughout the cities and villages of our nation is to prevent the abuse and suffering of animals. It is, if you please, a commitment which seeks to ensure that no animal which is the victim of neglect, abuse, or the lack of caring concern will continue to suffer.

Animal suffering in our society is pervasive. Sometimes that suffering is a consequence of outright abuse and cruelty; other times a result of the neglect and indifference of its owner. It also arises from the thoughtless and irresponsible way in which owners fail to take measures to prevent the breeding of these same animals.

There are throughout our nation today literally millions of dogs and cats born annually that are unwanted. By the millions these animals are brought to our shelters with the expectation that we will find them good homes. But the tragic reality is that most of these animals will be destroyed, more than 7 million this past year alone.

Mr. Chairman, we are not destroyers; rather, we are healers and comforters. And as such we must not be denied the right to minister to the needs of these animals that are sick and injured, abused and neglected, or condemned to die before they are born. However broad may be our understanding of the rights of animals, surely it cannot be denied that every animal, irrespective who its owner may be, has a right to receive medical care and attention. And that being the case, I submit that no humane society should ever be denied the right to provide that care.

Because of the millions of unwanted animals being born annually, a number of humane societies have established spay and neuter clinics for the purpose of helping to reduce this tragic overabundance of animals. And I am pleased to report, Mr. Chairman, that where such clinics exist, coupled with a program of community education and effective enforcement of animal control ordinances, we are beginning to win the battle. We must be permitted to carry forth this mission.

But beyond providing this kind of prevention of suffering medical attention, we must also be guaranteed the right to receive into our care any animal brought to our doors whatever its needs may be. Clearly, not all humane societies can or should operate charitable animal hospitals. And in fact, Mr. Chairman, at this time in history very few do.

By the same token, however, none should ever be denied that opportunity. For in the final analysis, unless the animal protection community is permitted to continue to minister to any animal in distress, whatever its need, it may very well not be cared for at all. For with a few exceptions, the private practice of veterinary medicine in this country is premised on the animal owner's willingness and ability to pay. The charitable animal hospital, however, exists for the ultimate benefit of any animal whether payment is possible or not.

I urge you and the Congress of the United States to ensure that the fulfilling of this mission of mercy will never be denied. Thank you, Mr. Chairman, for this opportunity to present this testimony, and I shall be pleased to attempt to any questions you may have. Thank you, sir.

[The statement of Mr. Hoyt and attachment follow:]

Statement of the Humane Society of the United States

MR. CHAIRMAN and members of the subcommittee, my name is John A. Hoyt. I am President of The Humane Society of the United States. On behalf of our more than 600,000 constituents, many of whom we share with you, I am honored to present testimony regarding Unrelated Business Income.

The Humane Society of the United States is the nation's largest animal protection organization, with a staff of 90 working in Washington, DC, and eight regional offices around the country. We work in cooperation with more than 2000 humane societies across the country, and we were chartered for the purpose of preventing suffering and abuse to animals. We pursue this objective through education, investigation, litigation, and legislation.

In addition to The Humane Society of the United States, I am also president of the World Society for the Protection of Animals, an international organization based in London.

Humane societies were first chartered in the 19th century in this country. From their chartered origins to the present day, many humane societies have operated veterinary facilities. These facilities have been essential to the societies' fulfilling their chartered responsibilities. The veterinary function of humane societies has continued unchallenged until recent times.

The task of humane societies is to establish the humane ethic and to encourage compassion where it is lacking; to mend broken limbs and to restore ailing creatures; and finally, to confront the reality and the causes of cruelty. Humane societies work within the framework of our laws to accomplish these goals, utilizing tax-exempt dollars.

Since inhumanity rears its head in different guises, the humane society must be as facile and energetic in combating cruelty as the human mind is in devising it; because it is from the human mind that most cruelty originates—even though it is not always maliciously intended.

We are a nation of citizens that spends billions on our pets; yet we euthanatize approximately 8 million dogs, cats, puppies, and kittens each year. These millions and many more that don't land in shelters wander the streets as "strays," are injured or killed, go hungry, or suffer from disease. All humane societies in the United States have documentation of these common abuses.

Animal Control departments in the United States spend hundreds of millions of tax dollars to pick up animals from the streets, hold them in cages, euthanatize them, and dispose of their carcasses. Many cities spend more money on animal-control measures than on their entire school lunch programs. For more than a quarter of a decade, the U.S. Conference of Mayors has noted that citizen complaints about animal-related problems are the most frequently and plentifully received. Each and every day, humane societies continue to be the major force in this country seeking to curb the serious pet overpopulation explosion. Companion animal problems must be confronted through education, spay-neuter programs, cruelty investigation and prosecution programs, and legislative efforts.

It is only through the diligent efforts of humane societies and the generous charitable contributions of their members that these needless and tragic scenarios can be addressed. Just one example of a single humane society's successful efforts to control its community's overpopulation of dogs and cats is the Humane Society of Huron Valley, Ann Arbor, Michigan. Its ten-year study demonstrated that an aggressive education and low-cost spay-neuter program reduced animals taken in by 52% (from 18,000 in 1975 to under 9,000 in 1985) and that euthanasia dropped 60% (from 12,000 in 1975 to 5,000 in 1985).

The solution to the sad reality of pet overpopulation and abuse can come from only one source—the charitable organizations which are dedicated to combating these problems. And those humane societies that are among the best equipped to cause positive and lasting change are those that operate charitable animal hospitals. The veterinarians employed at these hospitals testify in cruelty prosecutions, operate the spay-neuter clinics, assist in emergency rescue programs, testify before legislatures in support of humane oriented legislation and against inhumane practices, refuse to perform cosmetic surgery, and provide invaluable data concerning the profile of animal health or neglect problems in an entire community. These actions allow a humane society to know where to most effectively focus its attention and best expend its scarce, donated dollars.

Veterinarians, as professionals, minister to an animal's physiological ailments, but they do so, typically, when the owner can pay, and they do not always do so for the actual benefit of the individual animal or the community of animals. Tail-docking, ear-cropping, declawing, and advice on breeding programs are services offered at most private veterinary clinics. They are services that are perceived to be in the interest of the owner; they are not services that are in the interest of the animal. Charitable animal hospitals have only one client: the animal. More appropriately, these hospitals service the community of animals, because they function as an integral part of the humane society, in furtherance of its tax-exempt goals and long-range objectives.

Charitable animal hospitals offer veterinary treatment to any animal, regardless of the owner's ability or willingness to pay. Sliding-scale fees, indigent-fee arrangements, extended payment plans, as well as free services, are available. The animal whose owner can afford a full fee is treated alongside the animal whose owner can't afford a full fee. However, vital animal health data and a profile of community animal problems cannot be obtained without a good cross-section of a community's animal clients. It cannot be obtained from data about urban problems only; interface with a representative number of animals from suburban areas is mandatory. Nor could a humane society's other programs survive in the progressive state they have achieved without the full-pay as well as the no-pay, the reduced-pay, or the extended-pay client.

The national office of the Internal Revenue Service (IRS) has already determined that one humane society that operates a progressive and effective humane program in its community lawfully operated charitable animal hospitals. The existence of those hospitals was determined by the IRS to further the exempt purposes of the organization, to help in the prevention of cruelty to animals, and to provide the charitable function of giving to domestic animals the right to medical care. In order to lawfully operate a charitable animal hospital, a humane society cannot undercut private veterinary hospital fees, cannot operate clinics so that a substantial portion of the society's income is derived from that source, and must be able to demonstrate that the operation of the hospitals is "directly and substantially related to the society's charitable purpose." Thus, the formula used by the IRS is a workable, equitable, and sensible formula. It strikes a balance between the monetary concerns of the private veterinary sector and the charitable goals of the humane movement. If the private veterinary community is currently facing a financial crunch because of its own internal manpower and marketing problems, the solution is not to lay the blame at someone else's door.

The fact that competition might arise between a charitable animal hospital and a private veterinary clinic was addressed by an IRS finding:

> "The key question here is whether the Society has operated its veterinary service activity in such a fashion so as to override any related purpose. It appears that an appropriate balance has been reached here. The fees charged here tend to encourage pet owners who are able to afford care from the private sector to seek such care yet still enables the Society to maintain full veterinary care. Free care to all would tend to cause unfair competition with the private sector. There is no indication that this organization could better accomplish its exempt purposes by refusing to provide veterinary services to animals whose owners are able to purchase such services from the private sector. There is no evidence that this organization has promoted the fee producing segment of its services; the evidence suggests the opposite. Because the activity itself furthers section 501 (c) (3) purposes, a finding of relatedness is not dependent on a finding that a gift has been made to the indigent or that a gift has been made to a section 501 (c) (3) organization. The activity is substantially related to the Society's exempt purposes." (TAM-LTR8450007)

Because of the difference in function between a private veterinary clinic and a charitable animal hospital, the latter's operation is not considered to be an unrelated business activity upon which an unrelated business tax must be paid. It is not the operation of an unrelated business by an animal-protection charity which the organized veterinary community is attempting to undermine; it is, in fact, an attempt to take away the charitable organization's ability to effectively help animals.

As a civilized society, we find cruelty to animals repulsive and unacceptable. Humane societies investigate and prosecute cruelty cases, educate, attempt to influence laws toward humane ends, and set into motion mechanisms which will promote a more humane and compassionate world. An important factor in furthering those goals continues to be the operation by humane societies of charitable animal hospitals. Humane societies have always operated such facilities; their doing so has not been challenged until recently. When it was challenged, however, the IRS responded in this manner:

> "Further, the manner in which veterinary services are provided distinguishes the activities of...[a charitable animal hospital] from a private veterinary clinic. A private veterinary clinic is operated for the private benefit of the veterinarians affiliated with the clinic and the owners of the animals treated.
>
> "In contrast, the primary concerns of [a charitable animal hospital] are the animals being treated and the animal population in general. Consequently, in addition to treating animals brought to the clinic, the organization educates the owners of those animals on the proper care of their animals and strongly encourages owners of the animals to have the animals neutered in order to prevent the birth of unwanted animals and, thus, to prevent cruelty to animals. If a veterinarian at one of the clinics finds that an animal brought to the clinic is a victim of abuse, the owner is instructed on the proper care and treatment of the animal. After the initial treatment of the animal, the situation is monitored by the veterinarians in the form of follow-up clinic care and, if necessary, referral to the... [Cruelty] Department...In this way, the operation of the veterinary clinic also prevents cruelty to animals by preventing further abuse of the animal.
>
> "It also uses information obtained in treating animals at its clinics to keep track of which animal diseases and injuries are prevalent in a given area. It then institutes public information programs through community action groups, the school system, local community newspapers, and radio programs to educate the public on how to prevent these diseases and injuries to animals. In this way, the organization maximizes the potential benefit to the community from the operation of its clinic." (GCM 39346)

To restrict charitable animal hospitals beyond their current restrictions, or to eliminate them totally, may add a small increment to the private veterinarian's financial coffers, but it will mortally wound the "humane society" as it is currently known in our country.

Thank you, Mr. Chairman, for this opportunity to testify.

The Humane Society of the United States
2100 L Street, N.W.
Washington, D.C. 20037
(202) 452-1100

July 14, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Leonard:

I am writing to comment for the record in response to a statement made by Mr. John Motley of the National Federation of Independent Business before the Oversight Subcommittee of Ways and Means' hearings on the issue of unrelated business income. Mr. Motley stated:

"In several states local Humane Society facilities have expanded beyond providing spaying and neutering facilities to poor families with pets. Once established in the community, they reach out to the general community and, regardless of income, offer for-fee services including grooming and elective medical procedures, in direct competition with veterinarians who must pay taxes."

In most situations where humane societies have provided spaying and neutering services. it has never been the contention of these organizations that such services were exclusively for the poor. These services have almost without exception been provided to the public-at-large, generally on a sliding scale fee based on ability to pay.

Further, few if any charitable animal hospitals maintained by humane societies have ever provided services such as grooming or other cosmetic procedures. On the other hand, these hospitals have admitted and defended providing elective medical and surgical procedures necessary to the health and well-being of the animal.

I trust these comments will be included in the record.

Sincerely,

John A. Hoyt

John A. Hoyt
President

OFFICERS

Coleman Burke
Chairman of the Board

K. William Wiseman
Vice Chairman

Dr. Amy Freeman Lee
Secretary

John A. Hoyt
President

Paul G. Irwin
Executive Vice President/Treasurer

Murdaugh Stuart Madden
Vice President/General Counsel

Patrick B. Parkes
Vice President/Field Services

Patricia Forkan
Vice President/Program and Communications

Dr. John W. Grandy
Vice President/Wildlife and Environment

Phyllis Wright
Vice President/Companion Animals

Dr. Michael W. Fox
Scientific Director

DIRECTORS

Samuel A. Bowman
Dr. Carol Browning
Coleman Burke
Irene Evans
Regina B. Frankenberg
Harold H. Gardiner
Alice R. Garey
Gisela H. Karlan
John W. Kelly
William Kerber
Dr. Amy Freeman Lee
Jack W. Lydman
Virginia Lynch
Cherie Mason
John W. Mettler, III
John G. Mosher
Susan Pepperdine
O.J. Ramsey
Marilyn G. Seyler
Everett Smith, Jr.
Brook Speidel
Robert F. Welborn
K. William Wiseman

HONORARY DIRECTORS

Aida Flemming
Virginia Milliken
Andrew Wyeth

Chairman **Pickle**. Thank you, Mr. Hoyt. Our next witness will be Nolan P. Rubin. Are you a doctor?

Dr. **Rubin**. Yes, I am.

Chairman **Pickle**. Dr. Rubin, would you proceed, please?

STATEMENT OF NOLAN P. RUBIN, D.V.M., MONTROSE ANIMAL HEALTH CENTER

Dr. **Rubin**. Mr. Chairman, members of the committee, my name is Dr. Nolan P. Rubin. I am a veterinarian who has been engaged in small animal practice for 12½ years. For the past 8 years, I have owned and operated the Montrose Animal Health Center in Fairfax, VA. I have also served on the board of directors and have been past president of the D.C. Academy of Veterinary Medicine, the Northern Virginia Veterinary Medical Association, and the Emergency Veterinary Clinic of North Virginia.

Although I represent only myself today, I can assure that my views are shared by the majority of my colleagues in the private sector. The issue today is whether the revenue generated by the operation of full service veterinary hospitals run by nonprofit humane organizations should be considered as unrelated business income. The answer is an unequivocable yes. The reason for this is predominantly an economic one. It creates an extremely unfair business competition. The operation of these full service animal hospitals allows them to offer fees considerably lower than what the private sector can afford to charge the public.

To better understand this, some background in the economics and practice of the veterinary profession are in order. It takes a minimum of 8 years of college education to become a veterinarian. A recent article in the Journal of the American Veterinary Medical Association reports that the average indebtedness of the 1986 new graduate was $48,000 in student loans. It is important to note that the public's perception of our income is far greater than it truly is. In fact, Veterinary Economics reported this year that the national average income for small animal practitioners was $31,000, compared to physicians earning $109,000. Starting salaries for a new graduate here in Fairfax County, VA—incidentally, the county with the highest per capita family income—ranges only from $20,000 to $22,000.

Unlike our physician counterparts, we have to establish and maintain our own facility. My 8-year-old hospital located in a rental building cost me over $150,000 for leasehold improvements, furnishings and equipment. If I had to purchase land and construct a freestanding facility like most of my colleagues have done, you can see that many hundreds of thousands of dollars can be invested.

There are numerous other costs of operation involved. Medical, surgical supplies, utilities, labor, office supplies, are just to name a few. We also pay our fair share of taxes, including business, personal property, income, utility tax, sales tax, business licenses, gross receipts tax, income tax both personal and business.

Disregarding even a reasonable return for capital investment which would make this scenario even worse, one can easily see that the operation of a veterinary hospital is quite substantial with only a small personal monetary return. We cannot survive when we are forced to compete in a marketplace where many of these obligations have been removed. The consumer is always looking for a bargain and will choose the lower fees for equal services regardless of his or her ability to pay.

It is important to note that in the Detroit, Mich. area several private animal hospitals were forced to close while all reported reductions in gross income when located in an area where humane society tax exempt hospitals were being operated. A similar situation occurred in Virginia Beach, VA.

Not for a moment can one consider the veterinarian only be mercenary. We share the same goals and ideals as the humane societies. Namely, the relief of animal pain and suffering, the placement of abandoned and unwanted animals, a solution to the pet overpopulation problem, and the public education for responsible pet ownership. Unfortunately, the private veterinarian receives little or no recognition for his efforts. There is not a week that I do not treat animals without compensation, injured wildlife or strays. I also place unwanted pets into new homes. Also, people are not refused services because of their inability to pay.

We in Fairfax County work cooperatively with the county shelter and department of animal control in cosponsoring a reduced cost rabies vaccination clinic staffed by volunteer private practitioners. We also have sponsored reduced cost spay-neutering and free health examination program for all animals adopted from the shelter. This has been in existence for over 15 years. However, the majority of the public perceives this to be a county government program.

Lastly, the Emergency Veterinary Clinic of Northern Virginia, privately owned, has agreed to treat all emergency cases brought in by animal control wardens for a flat fee of $15. And this has not been raised in our 10-year history. This illustrates that the for-profit veterinary community can work together with the humane organizations for a common goal of improving the welfare of the animal population.

This leads us to why tax exempt organizations establish hospitals. And that is to generate revenues which is not unlike the privately owned hospitals. In their case, the revenue is used to supplement their donations, grants and gifts in the operation of their organization.

There is no difference in the concerns of either the privately owned or the tax exempt hospitals. Both are operated to generate money while caring for the needs of their patients. This establishes them as operating an unrelated business activity whose function is outside the intent of the law.

Humane organization run animal hospitals attract a large majority of clients because of their implied charitable purpose and dedication to the goal of humane treatment of animals. This is the so-called halo effect. This clientele would have otherwise been served by the private for-profit animal hospitals. Most of the humane society run hospitals make their services available to those who can afford to pay the market fee. This jeopardizes the very existence of private veterinary practice. Could this not lead to a state of socialized veterinary medicine?

It is my understanding that humane societies argue that they are not doing certain types of veterinary services such as defanging, debarking, ear cropping, boarding, grooming, training, et cetera. The implication seems to be that this work is left to the private veterinarian to perform and is therefore non-competitive. Let me set the record straight.

First of all, procedures as debarking, defanging, ear cropping, et cetera are the very procedures these societies argue to be inhumane. I, and most of my colleagues concur that they are unnecessary and mutilating and refuse to perform them. Other services such as boarding, grooming, training, although ancillary in some animal hospitals do not even require a license to practice veterinary medicine. Lastly, all of this leftover that the humane societies use as their argument as being noncompetitive represents a mere fraction of our total business volume.

Furthermore, let me refer to IRS General Counsel Memo 39346 dated 4/30/84:

> A private veterinary clinic is operated for the private benefit of the veterinarians affiliated with the clinic and the owners of the animals. In contrast, the primary concerns of Society A are the animals being treated and the animal population in general.

This is insulting and misleading and could not be further from the truth. I have a love for animals. I have treated injured and sick birds, and wildlife, and strays without compensation. I have concerns for animals being treated and the animal population in general.

The fact still remains that humane society animal hospitals are operated to generate revenue in the same manner as my animal hospital. This represents an unrelated business activity to their charitable efforts and should not be tax exempt.

I thank you for this opportunity to express my views and opinions and welcome your questions.

Chairman PICKLE. Thank you, Dr. Rubin. Now, Mr. Wills.

STATEMENT OF DAVID K. WILLS, EXECUTIVE DIRECTOR, MICHIGAN HUMANE SOCIETY

Mr. WILLS. My name is David Wills, and I am the executive director of the Michigan Humane Society with our headquarters in Detroit, Mich.

We at the Michigan Humane Society operate three full service shelters, one in downtown Detroit, one in Oakland County, and one in western Wayne County. And in each full service shelter we have a full service animal hospital.

And I just would like briefly to talk about our finances. Last year, the Michigan Humane Society spent roughly $3 million. We are audited every year by Touche Ross, so our audits are on public display on file with the State of Michigan. We receive $1.75 million of our funds from public revenues: donations, membership dues, endowments and foundations.

We received $800,000 from our veterinary operation. That was our gross take. We lost last year, as an audited number, approximately $120,000. The expenses of our animal hospital exceeded our revenues by that much. I sincerely challenge the allegation that the Michigan Humane Society operates its clinics to make money. If we do, we are very poor businessmen.

Because of our uniqueness in the Michigan area, the Michigan Humane Society has had the opportunity to be under the IRS microscope. I have heard a great deal here today about wanting these rules to be enforced, wanting these regulations to be upheld and wanting people to be scrutinized. The Michigan Humane Society underwent a 2-year investigation by the IRS in 1982 and 1983. Every book, every animal, sometimes I thought every cat was examined by the auditors.

Then we came down to Washington after IRS had done its investigation and sat before a panel of the IRS. It is from the ruling in our case that so many people here today have quoted from which said unequivally that the purpose of operating a full service veterinary hospital by the Michigan Humane Society is not implicitly, but directly related to its charitable activities. I doubt if any other humane society in the United States has been under that type of scrutiny.

The interesting thing, I thought, about our ruling that seems to be lost here today is that there is a clear distinction between the role of a humane society and the role of a private practitioner with regard to animals. I do not at all demean all veterinarians. There are many caring, decent veterinarians who provide a great deal of free services in their own clinics for animals. However, that is not their mission. Their mission is to make a living for themselves, and I respect them for that.

But to suggest here today that private veterinary medicine and the humane community have always been best buddies walking down the primrose path together, working for the ending of all the animal problems in the world is false and misleading. First of all, private veterinary has fought everything from spay-neuter clinics, to full service hospitals, to various other issues that are in the animal welfare, animal protection field.

Even more interesting is the fact that the Michigan Humane Society employs 12 State-licensed veterinarians—five from, I think, Michigan State University and a couple others from the rest of the Midwest—veterinarians who choose to practice in our hospitals because they, as licensed veterinarians, having gone through the same training and education as other veterinarians believe in our philosophy and our purpose.

I think it has got to be pointed out here that the Michigan Humane Society last year saw 5,000 cases of the most grotesque abuse you can believe in the heart of downtown Detroit, MI. It is not an easy situation that we deal with. Our veterinary hospitals are absolutely essential to what we do.

You have my written testimony as far as the IRS ruling, how it came about. It has been a long and lengthy process, and I know today's hearing is long, too.

I would like to close with a small quote that I would like to read because I think this is kind of an interesting tangential item to this whole issue. I have had a long and somewhat respectful relationship with Dr. Harold Knirk who is in the audience today and whom in the Michigan battles we have had occasion to face on opposite sides of the fence.

In 1982, Dr. Knirk wrote a letter that was later published in the Journal of American Veterinary Medicine which said, referring to veterinarians: "We lose clients for several reasons: 68 percent quit because of discourteous or indifferent treatment; 14 percent because of grievances not resolved or adjusted; 9 percent are lured away because of lower prices; 5 percent are lured away because of the influences of others; 3 percent move and 1 percent die." In summary Dr. Knirk wrote: "82 percent leave for the first two reasons, both of which fall under our control."

The Michigan Humane Society has been scrutinized by the IRS. We do not undercut veterinarians prices, do not advertise our hospitals and do not take advantage of our tax exempt status to accept donations for services rendered. Last year we filed a 990 and paid about $1,700 in unrelated business income tax on the sale of T-shirts and bumper stickers that we felt were questionable even under current law, because ethically we think there is a fine line as has been stated earlier.

I would really love to see about half of the committee sometime visit us and see what we do. I think you might get a bit different picture of exactly how a humane society works in an inner city and why a humane society, whether it be in Oakland County near Pontiac, or in western Wayne County near unemployed automobile workers or in downtown Detroit, feels that it has to operate an animal hospital along the guidelines that the IRS has approved, because without it we do not have a chance of fulfilling our mission.

Quite frankly, our work is depressing enough as it is. If you take away the one weapon that we have that impinges on our rescue mission and on our ability to deal with our problems, it becomes almost hopeless.

Thank you very much.

[The statement of Mr. Wills and a subsequent submittal follow:]

STATEMENT SUBMITTED ON BEHALF OF THE MICHIGAN HUMANE SOCIETY

Mr. Chairman, I am David Wills, Executive Director of the Michigan Humane Society. With me is Ms. Sienna LaRene, our General Counsel.

The Michigan Humane Society was founded in 1907. It is a private non-profit organization recognized by the IRS as tax exempt under Section 501c(3). The organization does not engage in any activity which subjects it to the tax on unrelated business income. The Michigan Humane Society is funded primarily by the contributions of approximately 37,500 member/donors throughout the state of Michigan. In our various facilities and programs, we house or treat more than 40,000 animals each year.

Today I will address the question of whether the revenue derived from the operation of animal hospitals by animal protection organizations should be considered as unrelated business income. It may interest you to know that the IRS has considered this issue with respect to our Society and has found that our activities are fully in compliance with current law pertaining to unrelated business income. I will briefly outline the activities of the Michigan Humane Society so that you can fully understand why our animal hospitals are an integral part of our tax-exempt activities.

The Society operates an animal adoption service, an ambulance service for injured animals, an animal cruelty investigation service, extensive education programs regarding the proper care for animals, a sterilization clinic in which animals are spayed and neutered, a wildlife rehabilitation service in which domestically raised wild animals can be returned to a natural environment and a euthanasia program in which unwanted and unadoptable animals are humanely destroyed.

The Society has operated an animal hospital since 1951. Currently we have three hospitals, all located in the Detroit metropolitan area. The Michigan Humane Society's animal hospitals are an integral part of its charitable tax-exempt activities. These hospitals primarily provide services to stray and abandoned animals. The hospitals also provide free and reduced-price care for animals owned by indigent people. The hospitals do not advertise the availability of their services to those who can afford to pay, but will provide limited service to animals owned by such people, at market-rate prices, when asked to do so. Many people want their animals to be treated by an organization dedicated to the goal of humane treatment of animals. The revenues derived from our animal hospitals are 100% devoted to our charitable and educational activities.

The Society's hospitals are not directly comparable to for-profit animal hospitals since there is a long list of services which they do not provide to anyone. These services include: commercial boarding, grooming, ear-clipping, tail docking, breeding services, de-clawing, de-fanging, de-barking, hunting or obedience training, dog show work or pedigree work. In all of these areas, these hospitals do not compete, directly or indirectly, with for-profit animal hospitals.

There has never been an objection to our providing free animal care to stray animals or to indigent people. It is in the area of providing service to paying customers where questions of unrelated business activity arise. Providing service to such people is an important part of the Society's effort to gather information on the care and condition of animals in all parts of the community, not just in those areas primarily inhabited by indigent people. The information gleaned from treatment of animals from throughout the community serves as a base for the Society's program to educate its staff, its membership and the community at large about patterns of disease, neglect and abuse, as well as other important issues in animal care. Of equal importance is the fact that these hospitals also allow the Society to establish a humane standard of care by which private for-profit animal hospitals can be measured.

The Society does not compete and does not seek to compete with for-profit facilities. In fact, through our extensive education programs, we constantly recommend that people utilize the services of private veterinarians. For example, we recommend that dogs and cats be checked by a veterinarian every six months. In that way, the Society is an important source of business referral for private for-profit animal hospitals. The Society also refers to private veterinarians those people who seek services which the Society does not provide.

The loss of the tax-exempt status of the Society's animal hospitals would cripple our ability to perform our charitable functions. Because of our high standard of care and because of our well-known willingness to care for every sick or injured animal, our hospitals receive substantial donations of cash and equipment. If these hospitals were not tax-exempt, many such donations would no longer be made.

One final point to keep in mind. If our opponents were to succeed in subjecting the Society's hospitals to taxation, they will have won a pyrhhic victory. The Society would continue to run animal hospitals. It must do so to care for the stray, neglected and abused animals it was set up to serve. If the Society were, in addition, to operate for-profit animal hospitals under the Society's well-earned reputation for humanity and integrity, other for-profit animal hospitals would be faced with truly formidable competition. The Society has no wish to do that. It merely wants to continue to carry out its charitable and educational functions.

Thank you for your consideration of our views. I would be pleased to respond to any questions you may have.

MICHIGAN HUMANE SOCIETY

COMMITTEE ON
RECEIVED
JUL 20
WAYS AND MEANS

OFFICERS
Harold M. Hastings
Honorary Chairman of the Board
Robert B. Sorock
President
Ms. Marilyn Turner
First Vice President
Mrs. Jack Marx
Second Vice President
Daniel Minkus
Secretary
Paul Heneks
Treasurer
David K. Wills
Executive Director

DIRECTORS
Ms. Linda Fuhrmann
Mrs. Richard Greer
Mrs. James Grosfeld
Peter B. Johnstone
John Kelly
Frank Crouse
Ross Lerner
Eugene W. Lewis III
Mrs. Frank Scott Perkin
Mrs. Arthur Rodecker
James D. Ross
Mrs. Frederick Ruffner
Mrs. David Sparrow
Mrs. Lucius Theus
Frank R. Wheeler
Jon C. Whiteman

ADVISORY COMMITTEE
Ms. Hadley Mack
Mrs. Oliver Dewey Marcks
Cleveland Thurber, Jr.
Mrs. Robert C. VanderKloot

HONORARY DIRECTORS
Addison D. Connor
Ms. Margaret Ferry
Mrs. George R. Fink
George Hatie
John P. O'Hara, Jr.

A NON-PROFIT ORGANIZATION SERVING WAYNE AND OAKLAND COUNTIES. CONTRIBUTIONS ARE FULLY TAX DEDUCTIBLE.

CENTRAL SHELTER
7401 Chrysler Drive
Detroit, MI 48211
872-3400

WEST SHELTER
37255 Marquette Road
Westland, MI 48185
721-7300

NORTH SHELTER
3600 Auburn Road
Auburn Hts., MI 48057
852-7420

July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
House Committee on Ways and Means
U.S.House of Representatives
Washington, D.C. 20515

Dear Mr. Leonard:

Our Society's lobbyist, William Brodhead, recently called my attention to comments submitted to the Committee by John Motley of the National Federation of Independent Business. On behalf of The Michigan Humane Society, I would like to take this opportunity to refute the accuracy of Mr. Motley's statements. Apparently he characterized humane societies as traditionally providing pet sterilization services to the poor, and then commented that in several states there have been cases where humane societies strayed far beyond that function, including by offering veterinary medical clinical "for-fee services including grooming and elective medical procedures in direct competition with veterinarians...".

In fact, humane societies have traditionally offered or promoted low-cost pet sterilization services to any and all petowners interested in taking advantage of such procedures. This historical function has been a cornerstone of the humane societies' charitable mission to do as much as possible to reduce the number of pets being born in the U.S., thereby, reducing the number that end up as strays, unwanted or euthanized in humane society shelters and public pounds.

Secondly, by definition, "Charitable Animal Hospitals" as pioneered and formulated by our Society and, thus, sanctioned by the IRS as legitimately non-profit and non-taxable entities within our overall organizational structure, do not make available to the paying, petowning public any elective cosmetic surgeries or other procedures or grooming and breeding services. Both The MHS and the IRS view such services as not in the best interests of the animals and, thus, not a part of the charitable function and goals of a humane society-operated clinic. These services are correctly left to the private sector veterinarians who perform them for profit. One clear illustration of this conceptual and pragmatic distinction would be the full-service veterinary medical clinic operated by The Humane Society of Macomb County (also in the southeastern Michigan region). This clinic performs such elective services, and that factor together with others that distinguish it from MHS Clinics, resulted in an IRS determination that it was not operating in accordance with its charitable charter and that this Society had to spin-off its clinic and make it a separate, for-profit and taxable entity.

I hope that I have clarified and responded to Mr. Motley's misconceptions. If you have any questions, please do not hesitate to contact me. Thank you for your continuing consideration.

On behalf of the animals and people we serve, I remain

Sincerely yours,

David K Wills

DAVID K. WILLS
Executive Director
The Michigan Humane Society
7401 Chrysler Drive
Detroit, MI 48211
(313-872-3400)

Chairman PICKLE. Thank you. I do not think anyone on this committee is trying to say to the humane society people that we really do not feel that you need to be in business. Nor are we saying to the private veterinarian that we ought to remove their tax exempt status. I think we mostly feel that there is a place for both, and I assume you have a basic feeling of the same thing.

The question is, is there unfair competition? Now, Mr. Cummings, you started off. I wanted to ask you, have local veterinarians in your city complained about your humane operations?

Mr. CUMMINGS. I am unaware, Mr. Chairman, of any friction between our organization and the veterinarians of Massachusetts. In fact, it may be partly because of the age and tradition of our hospital, a cooperative arrangement exists under which veterinarians refer many of their problem cases to Angell Memorial Animal Hospital and we accept them. And we also share our specialties with them.

I would say that I am unaware of any friction between the Massachusetts Veterinary Association and our organization.

Chairman PICKLE. No complaints? Dr. Hopkins, you contend that your veterinarians are having to compete and it is unfair and many of them have at different times gone out of business.

Dr. HOPKINS. Yes, sir, I do.

Chairman PICKLE. Do you know whether in Mr. Cummings' area that local veterinarians have objected, or is this just a general principle that you are taking?

Dr. HOPKINS. No, sir, I thoroughly agree with Mr. Cummings. The thing that we have got to take into consideration is that Angell Memorial Hospital has been there since most of those veterinarians were born—since before they were born. It has been an institution there. They came and went into practice there with that being a part of the community.

That is a far cry from a humane society opening a full service clinic in a neighborhood or any area that is already served by one or two private practitioners, and going in and using their tax exempt status to do things as blatant as advertising in the paper that their prices are lower because they pay no taxes.

Chairman PICKLE. Mr. Cummings, do you operate a full service function there at your clinic?

Mr. CUMMINGS. Absolutely, Mr. Chairman.

Chairman PICKLE. Mr. Wills?

Mr. WILLS. Yes, sir, we do.

Chairman PICKLE. Mr. Hoyt?

Mr. HOYT. Mr. Chairman, our organization does not maintain hospitals or clinics. We are a national organization that represents the interests of a lot of local societies.

But I would like to make just an observation, Mr. Chairman. And that is that we have many programs that are cooperative with veterinarians in their own facilities. Many spay and neuter programs throughout this country are cooperative ventures between humane societies and veterinarians and many are working splendidly.

And where those programs have tended to be successful, there has not been an inclination for the humane society to need to establish its own facility. It is where there has been a resistance, an unwillingness to cooperate by the veterinarians, that some humane societies have felt obliged to establish those programs to prevent the unwanted animals that we are desperately trying to fight.

Chairman **Pickle**. In what way have the private practitioners refused to cooperate?

Mr. **Hoyt**. They have been unwilling to enter into an arrangement with the local humane societies to provide spaying and neutering services at a somewhat reduced cost from those that they would normally charge their own clients.

Chairman **Pickle**. Dr. Hopkins, is that correct?

Dr. **Hopkins**. I would say in a limited number of cases that that is probably correct, except that I would hasten to say—and I think Mr. Hoyt would agree with me because he has agreed with me before about it—is that it takes two to tango, and the inability to get along is a two-sided problem. The personalities of the people in charge of some local humane societies are so abrasive and antagonistic that reasonable people cannot get along with them.

Where that situation has occurred, little progress has been made.

Chairman **Pickle**. Mr. Hoyt?

Mr. **Hoyt**. Mr. Chairman, I think one of the problems existing today is that the veterinary profession is overstaffed. I served as a trustee of the University of Pennsylvania School of Veterinary Medicine for a number of years. And at that time the Tufts University was attempting to establish a new veterinary school in New England where there was no veterinary college in all of New England. And the school of which I was a trustee fought desperately to keep Tufts University from establishing another veterinary college because of the already overabundance of veterinarians in private, small animal practice.

So there is competition between veterinarians for the services that are needed in our community today. And I submit, sir, that that is one of the reasons that they are feeling the pinch, and I think the humane societies are becoming the scapegoats of that overstaffed profession.

Chairman **Pickle**. Well, I asked a broad question. The operation of humane societies serve a very useful function. If that service were denied or were eliminated who would really be hurt; the public or the private practitioner?

Mr. **Hoyt**. The animals, Mr. Chairman, would be the ones that would be hurt the most because they would have no one, in the broad sense, to provide those services. There are, indeed, some exceptions, veterinarians who would take injured wildlife, who would take animals for whom there was no one to pay the bill. But that is the exception.

They cannot exist if they do not have it. But the charitable animal hospital, sir, has an obligation to accept those animals, and it would be the animal that would be hurt if we did not exist to do that.

Dr. **Hopkins**. Mr. Chairman, may I interject that in my statement I said that we have no objection to charitable animal hospitals. We have no objection to the care of stray animals and animals that belong to indigents. It is the opening of full service clinics, open to the public in neighborhoods with people that can clearly afford private veterinary care. To go in and utilize this ability to raise money from people that have written it off as a contribution, to build buildings, to staff those buildings and operate a clinic and pay no taxes.

That is ridiculous on the face of it, and we stand behind that forever. On the other hand, the point that Mr. Hoyt just made, we fully support. We definitely do.

Chairman PICKLE. Dr. Rubin was seeking recognition.

Dr. RUBIN. I wanted to make one comment when you were addressing Mr. Cummings about the Angell Memorial Hospital clinic. That is a very, very unique institution and is not representative of humane society run clinics in general. That really should be put in a class by itself. It probably represents closer to a teaching veterinary hospital than it does a humane society clinic. With their staff and what they do and their residency programs and what have you, they are probably more close to a university veterinary teaching hospital than they are to a humane society shelter clinic.

Chairman PICKLE. In a city of 200,000 people, would there normally be one humane society?

Mr. WILLS. Not necessarily. Humane societies are very much like colleges, you can have one or 20.

Chairman PICKLE. What is the average? My city of Austin, Tex. with 450,000, would it be one humane society?

Dr. HOPKINS. You have got one primary, longstanding very successful one. And then anytime anybody on their board of directors gets dissatisfied with something they do, then they branch off and try to start another one. So it is not a static number. You might have 5 or 6 this week and 4 or 5 next month.

But to answer your question, most cities the size of Austin will have one substantial ongoing humane society and then several splinter groups that will spring up over particular issues.

Chairman PICKLE. But normally a city has a humane society, maybe two?

Dr. HOPKINS. Maybe two, if it is as big as Dallas it has two.

Chairman PICKLE. And at the same time though, in that same city of that size there will be two dozen private practitioners, will there not?

Dr. HOPKINS. Or more.

Chairman PICKLE. So the public has a choice. Have private practitioners gone out of business because of these humane clinics? Do you know of anybody who actually went out of business?

Dr. HOPKINS. Yes, sir, in Michigan.

Mr. WILLS. Who?

Dr. KNIRK. The answer to that is the closing of satellite clinics where they had three and they had to close one because they lost the business.

Chairman PICKLE. What state was that?

Dr. HOPKINS. In Michigan.

Mr. WILLS. Mr. Chairman, that is a very important point that Dr. Knirk made. It has been publicized that doctors have gone out of business. First of all, that was the MaComb County Humane Society, which lost its tax-exempt status briefly and had to reorganize its clinic as a for-profit hospital. But the veterinarian did not go out of business. He operated three clinics and his reason for closing one of his satellite clinics was allegedly due to competition from the humane society, which may or may not have been the case. I am sure he thought it was.

But the point is that the local humane society underwent scrutiny, and that humane society was found to be operating outside of its scope, and the existing law dealt with it. And I think that is something that needs to be recognized here.

Chairman PICKLE. At least we can say there has been one or some more, but most of them, though they have not closed have been hurt because of unfair competition at least.

Dr. HOPKINS. Certainly, and again it is the trends. It is still a very small number, but it needs to be nipped sometime before it is a huge national problem.

Chairman PICKLE. How do we settle this squabble between your groups?

Mr. HOYT. Mr. Chairman, again, I think it is a very small problem. But also what should be remembered is that humane societies have the capacity to provide employment for veterinarians. We do not create these vets, they are graduated from the vet schools, they are licensed by the state boards. The Michigan Humane Society employs 11 full time veterinarians. If they were not employed there, they would each be building their own private hospital and competing with 11 other veterinarians somewhere else.

So I think that not only do we not represent serious competition, we provide employment for veterinarians.

Mr. WILLS. Mr. Chairman, if I may answer your question. One of the things that we had hoped for in Michigan, because of this controversy, was that the technical advice memorandum, which I think we have delivered to this committee, the ruling that affected the Michigan Humane Society, could solve the problem. It pretty much set up clearly the guidelines of what is directly related and what is not directly related to a humane society's purpose. And it very clearly stated the conditions under which a humane society starts to transgress into areas that constitute unfair competition.

And the proof of that is the fact that the Michigan Humane Society does operate a hospital within about 14 miles of the humane society that Dr. Hopkins was talking about, and the MaComb County Humane Society did lose its tax-exempt status for that hospital. So it seems to me that there is an arbitrator and that there is a system which works.

What I would like to see, of course, is a general revenue ruling that defined the parameters that a humane society had to operate within. I think that would help everybody.

Chairman PICKLE. The problem as I see it is your humane operation, society operation you offer full services the same as a private clinic or anybody else, yet you pay no UBIT. Unless you admit it is unrelated, you pay no UBIT taxes, so you can operate cheaper. Now the question is, is that in the public interest as a humane society or not? And I think that is a question we have to ask ourselves.

Mr. CUMMINGS. If I might be heard, sir. I think there is a myth that is floating about that we can operate more cheaply. I think the true fact is that we cannot. We are providing free services, and additional services that are as much of an expense on us as are taxes on a private clinic. And were we to be taxed, we could not provide the services.

We are not different from a teaching hospital, which is infinitely more expensive than a community hospital, or a hospital which does not provide teaching. In addition, we do not give services out any cheaper than a private veterinarian does, so that we are not competing with them.

Chairman PICKLE. Gentlemen, there seems to be a reasonable sharp difference of opinion on this subject, and this may be typical of a lot of different organizations. But you have all given us good testimony, and I know you all presented it in a sincere manner, and the committee is just trying to make the record as best we can to see what our problems are.

We thank you very much for your cooperation. If you have any other information or suggestions that you want to pass on to the committee, we invite you to do so. We thank you very much.

Now that completes the panels and the testimony for today. The committee will resume again in the morning at 9. We will resume in this room, and we have to vacate—we will attempt to finish by 2 tomorrow then. The committee stands adjourned until in the morning.

[Whereupon, at 3:25 p.m., the subcommittee hearing was adjourned.]